No. 84-1302

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In the Supreme Court of the United States

OCTOBER TERM, 1984

SHELL OIL COMPANY,
Petitioner,

vs.

THE PINEY WOODS COUNTRY LIFE SCHOOL, ET AL.,
Respondents.

APPENDIX TO PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FIFTH CIRCUIT

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APPENDIX

APPENDIX A

The PINEY WOODS COUNTRY LIFE SCHOOL, Ridgway Management, Inc., D'Lo Royalties, Inc., James H. Stewart, Jr., Rubinette Stewart, Diana Stewart Whitehead, Milton Monroe Stewart, Sr., Mrs. Willard Stewart Mitchell, Virginia Hansell Stewart, Individually, and as Trustee for the Benefit of Mrs. Carol Stewart Scott, Milton Monroe Stewart, Jr. and Thomas Hansell Stewart, Mrs. Maggie Fairley Spengler, Thomas L. Spengler, Albert L. Fairley, Jr. and James V. Fairley, Executors of the Estate of Alethe V. Fairley, Individually, and All Others Similarly Situated, Plaintiffs,

v.

SHELL OIL COMPANY, Defendant.

Civ A. No. J74-307(R).

United States District Court,
S. D. Mississippi,
Jackson Division.

May 3, 1982.

Royalty owners brought class action against lessees under gas leases claiming that lessees had improperly charged royalty owners for processing their share of production from subject fields, that lessees breached their duty under expressed and implied covenants to market, and that lessees method of calculating royalty payments on basis of proceeds received from sale of natural subject gas

rather than its "market value" was in violation of certain of lease agreements. The District Court, Dan M. Russell, Jr., Chief Judge, held that: (1) both lessor and lessee of gas lease would be required to equitably bear proportionate cost of materially enhancing value of gas; (2) lessee did not breach its duty to market by failing to procure price renegotiation clause in contract for sale of gas; and (3) royalty owners were entitled to receive royalty computed on "market value" for off-lease fuel used by lessee.

Order to be entered.

1. Mines and Minerals (Key) 79.1(1)

Under Mississippi law, "royalty" is defined as "a share of the production or profits reserved by the owner for permitting another to use or develop his property."

See publication Words and Phrases for other judicial constructions and definitions.

2. Mines and Minerals (Key) 79.1(2)

Under Mississippi law, working interest is distinguished from royalty in that royalty is share of production free of any costs of discovery and production with no right to do any act or thing to discover and produce oil and gas; working interest in minerals, the primary developer, on the other hand, is responsible for costs of discovery and production in addition to being given right to discover and produce oil and gas.

3. Mines and Minerals (Key) 79.1(1)

Under Mississippi law, it is common knowledge that landowner does not and usually could not, himself provide money, therefore, usual and almost universal method for finding oil and bringing it to surface is for landowner

to authorize person or corporation engaged in such business to find oil and bring it to surface, approximating all that he produces thereby to himself except agreed portion thereof reserved by and to be delivered, or its value paid, to landowner and usually designated as royalty.

4. Mines and Minerals (Key) 79.3

Royalty is customarily subject to proportionate share of costs incurred subsequent to production where, as is usually the case, royalty, or nonoperating interest, is payable "at the well"; among these costs borne by nonoperating interests are gross production and severance taxes and manufacturing costs incurred in extracting liquids from gas or casinghead gas, viz., costs incurred in adding value to wellhead product.

5. Mines and Minerals (Key) 79.3

Under gas royalty leases, production ceased once product was extracted from the earth and function performed by plant was subsequent to production and was a processing function whereby large expenditures were made to convert valueness commodity into one of greater value.

6. Mines and Minerals (Key) 79.3

Under gas leases, costs which are essential to make commodity worth anything or worth more must be borne proportionately by those who benefit.

7. Mines and Minerals (Key) 79.3

Even though lessee of gas lease may be under duty, express or implied, to market production, this duty does not require an assumption of all costs.

8. Mines and Minerals (Key) 79.3

Both lessor and lessee of gas lease must equitably bear proportionately the cost of materially enhancing value of gas and, thus, costs of removing hydrogen sulfide, processing it into elemental sulphur, and producing dry methane gas from sweet gas stream were properly deducted from royalties share of production and furthermore, initial capital investment by working owner to construct plant where those operations took place and return on that investment were also properly deducted, notwithstanding obligation of lessee to market production.

9. Mines and Minerals (Key) 78.1(8)

Because of lessee's exclusive control over production and development of oil and gas, law imposes upon lessee implied covenants of reasonably developing, producing, operating and marketing production.

10. Mines and Minerals (Key) 78.1(2)

A lessee under gas lease, bound by implied obligations, is held to standard of conduct, in Mississippi, of the prudent operator and test for his performance generally applied is whether or not lessee has used due care and diligence.

11. Mines and Minerals (Key) 78.1(1)

Due care and diligence required by lessee under gas lease in Mississippi is that care and diligence which would be exercised in particular situation with due regard to interests of both lessor and lessee and furthermore, reasonable diligence on part of lessee must conform to, and be governed by, what is expected of persons of ordinary prudence and industry under similar circumstances, conditions, practices and procedures.

12. Mines and Minerals (Key) 78.1(8)

Failure of lessee under gas lease in Mississippi to procure price renegotiation clause in contract for sale of gas was not breach of its implied duty to market the gas as a reasonable prudent operator in the exercise of due care and diligence.

13. Mines and Minerals (Key) 79.3

Gas sales contracts which designated field delivery points as points of sale for subject gas embodied true intentions of parties and were controlling for determining royalty payments computed on "market value" of subject gas. Miss.Code 1972, §§ 75-2-105(4), 75-2-501(1).

14. Mines and Minerals (Key) 79.3

Under provisions of gas sale contract, sales of gas produced at Rideway # 1-R and the Cox-Harper wells occurred in lease on which well was located; sales of gas from Garrett # 1-R well, on designated unit; and, for the Crain # 1 and L. D. Burch # 1 wells, at respective field delivery points located near inlet of plant. Miss.Code 1972, §§ 75-2-105(4), 75-2-501(1).

15. Mines and Minerals (Key) 79.3

Under commercial provision in gas lease, royalty owners were entitled to be paid for their share of production sold computed on market value of all gas sold or used, unless sale of such gas occurred at well and royalty was entitled to their share of production computed on market value where gas was sold or used off the premises, subject again to condition that royalty be computed on amount realized when gas was sold at well.

16. Mines and Minerals (Key) 79.3

For purposes of determining whether sales of subject gas occurred "at the well," a determination to be used in computing royalty payments, sale of gas upstream of plant at points where respective raw gas streams are metered prior to said gas' being commingled and processed were sales made "at the well" and, thus, royalty owners would be compensated for their share of production sold under subject contracts based on amounts realized from such sales.

17. Mines and Minerals (Key) 79.3

The term "market value," as found in royalty provisions in gas leases, meant current market value rather than contract price. Miss.Code 1972, §§ 75-1-101 et seq., 75-2-105 to 75-2-107.

18. Evidence (Key) 555

In action wherein royalty owners sought royalty payments, data relied upon by royalty owners' expert in formulating his opinion regarding market value of gas failed to satisfy applicable comparability test and his method of computation failed to accommodate necessary factors in determining market value of subject gas and, thus, court would not accept expert's testimony.

19. Mines and Minerals (Key) 79.3

For purposes of determining market value of gas for purposes of computing royalty due under gas lease, legal comparability of sales in oil and gas industry requires that sales be comparable in time, that gas be comparable in quality and that sales be derived from those whose availability to marketing outlets is similar to gas in question.

20. Mines and Minerals (Key) 79.3

For purposes of computing royalties under gas leases, sales of sweet gas cannot be compared to sale of subject gas which, in its raw state, is sour; however, subject gas would be comparable to sweet gas in that it was processed prior to marketing.

21. Mines and Minerals (Key) 79.3

For purposes of determining royalties under gas leases in Mississippi, once relevant market area is defined and comparable sales are identified, computation of market value should be made by division of net sales receipts derived from sales of comparable gas, after necessary adjustments for variances in BTU content and compression charges, by total volume sold.

22. Federal Civil Procedure (Key) 2737

Before award of reasonable attorneys' fees for willful disobedience of court order or when losing party has acted in bad faith, vexatiously, wantonly, or for oppressive reasons may be awarded, it is essential that successful litigants substantiate existence of "bad faith" by unsuccessful litigant.

23. Federal Civil Procedure (Key) 2737.5

In action by royalty owners to recover royalties under gas lease, record was totally devoid of any basis for awarding attorneys' fees and costs against lessee under the "bad faith" exception to the American Rule.

24. Interest (Key) 39(2)

Under Mississippi law, prejudgment interest may be allowed only in cases where amount alleged due was liqui-

dated when claim was originally made or where denial of claim was frivolous or in bad faith.

25. Interest (Key) 39(2)

In royalty owner's action seeking royalties under gas lease, under Mississippi law, in view of fact that amount allegedly due was not liquidated when claim was originally made and that denial of claim was not frivolous or in bad faith, royalty owners would not be entitled to prejudgment interest.

Ernest G. Taylor, Jr., Watkins, Pyle, Ludlam, Winter & Stennis, Kenneth I. Franks, George F. Woodliff, III, Heidelberg, Woodliff & Franks, L. Arnold Pyle, Barnett, Alagia & Pyle, Jackson, Miss., for plaintiff.

W. F. Goodman, Jr., Paul Stephenson, Watkins & Eager, Jackson, Miss., Alvin B. Gibson, New Orleans, La., William Simon, Keith E. Pugh, Jr., James Robert Fox, Washington, D. C., for defendant.

OPINION

DAN M. RUSSELL, Jr., Chief Judge.

Piney Woods Country Life School, Ridgway Management, Inc. and other named plaintiffs brought the instant action, individually and on behalf of a putative class[1]

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1. Exhibit P-6 is a list of members in the plaintiff class as finally certified: Mrs. Henry V. Bailey; A. C. Barton; Roddie C. Berry; Gussie Mae Berry; Black Warrior Minerals, Inc.; R. T. Boteler; H. J. Boyd; Lee Dora Burch; Jack F. Burke; Ralph C. Butler; Agnes Chapman Butler; Colaro Corporation; D'Lo Royalties, Inc.; W. R. Fairchild Const. Co. Ltd. in care of the Merchants National Bank of Mobile; Wiley Fairchild; Albert L. Fairley, Jr.; James V. Fairley; Dorothy H. Gillespie; Georgia L. Jenkins Glissom; Mrs. Zoe P. Hall; Hattiesburg American Publishing Co.; Hayes Petroleum Inc.; H. A. Hedbert; Mrs. Noreen Hogg; Ann Hough Hopkins; Don F. Hugus, Jr.; George D. Hunt; Mary C.

(Continued on following page)

designated as all royalty owners in the Thomasville, Piney Woods and Southwest Piney Woods Fields, and other contiguous fields located in Rankin County, Mississippi, whose natural gas is being, has been and/or will be processed through Shell Oil Company's Thomasville Plant Facility. By their complaint, Plaintiffs challenge the propriety of royalty payments made by Defendant, Shell Oil Company (hereinafter referred to as "Shell"), on natural gas produced from five units[2] in the Thomasville, Piney Woods, and Southwest Piney Woods Fields. Specifically, Plaintiffs allege that: (1) Shell has, and is, improperly charging royalty owners for processing their share of the production from the subject fields at its Thomasville Plant; (2) Shell breached its duty under express and implied covenants to market by its alleged failure to obtain the highest and

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Footnote continued—

Jenkins; Velma R. Jenkins; Lawson Johnson; Louis Johnson; Louise Johnson; Mary Johnson; James E. King, Jr.; Lignum Oil Co.; W. Baldwin Lloyd; Mary C. Lynn; Deposit Guaranty National Bank, Assignee of A. W. Magruder, Jr.; M. H. Marr; E. B. McGehee; H. C. McGehee; Rev. Julius A. McRaney; Kenneth Allen McRaney; Merchants National Bank of Mobile, Assignee of Lester Meng, Jr.; Betty D. Mortimer; Glenn G. Mortimer, Jr.; Aline F. Neal; Walter R. Neill; Deposit Guaranty National Bank, Assignee of John D. Noble; Pachuta Corp.; Edith Perkins Patton; First National Bank of Jackson, Trustee under the Kathryn Susan Parsons Perez Trust; Peoples National Bank of Tyler, Texas, Trustee (Pirtle Trust); Dr. David L. Perkins; The Piney Woods Country Life School; T. S. Price; Louise M. Reese; Ridgway Management, Inc.; L. P. Rush Citizens Bank of Hattiesburg, Trustee of the L. P. & Eunice H. Rush Trust; Carol H. Ryan; Katherine Westbrook Ryan; Thad J. Ryan; Thad J. Ryan, Jr.; Sabine Royalty Corp.; Ralph V. St. Johns; R. H. Sims; Guy W. Smith; Thomas L. Spengler, Jr., individually, and as Executor and as sole and only heir of the Estate of Maggie Fairley Spengler; G. G. Stanford; Sun Oil Co.; F. M. Tatum; Will S. Tatum; Joe A. Thompson; Robert L. Thomsen; Mrs. Jessie Neal Vaughan; Caroline Neal Vaughan; E. H. Wilkins; Watson W. Wise.

2. A sixth unit, on the Spengler # 1 well located in the Thomasville Field, has begun production since the filing of the instant action.

best price for gas sold to its primary purchaser; and finally, that, (3) Shell's method of calculating royalty payments on the basis of proceeds received from the sale of the natural subject gas rather than its "market value" is in violation of certain of the lease agreements. As relief, Plaintiffs request this Court to order Shell to pay to each of the named plaintiffs and to each class member their respective share of royalty computed on "market value" of the subject gas without deductions for expenses or charges incurred in processing or transporting.

Plaintiffs also allege that Shell violated the Sherman Act, 15 U.S.C. Sections 1 and 2, by an alleged illegal restraint of trade and commerce in the production, processing and sale of sour gas, sweet gas and sulphur, and by an alleged monopolization of the production, processing and sale of sour gas, sweet gas and sulphur in the geographic area consisting of the Thomasville, Piney Woods and Southwest Piney Woods Fields. On Defendant's Motion for Summary Judgment pursuant to F.R.Civ.P. Rule 56(c), this Court previously considered and disposed of Plaintiffs' antitrust claims, excepting from its finding Plaintiffs' claim under Section 1 of the Sherman Act which relates to Shell's alleged restraint of trade in its interstate sales of sulphur. As stated in its Opinion of December 3, 1976, the Court found that a genuine issue of material fact existed regarding the determination of the relevant market for sulphur sales and that further development of proof on this issue was appropriate. At trial, Plaintiffs offered evidence of Shell's allegedly monopolistic practices for the purposes of appeal. However, Plaintiffs declined to go forward with proof on the alleged Section 1 violation. The Court hereby finds and concludes that such claim should be dismissed.

On December 28, 1976, the plaintiff class was tentatively certified under F.R.Civ.P. Rule 23 as including all

royalty interest owners in Thomasville, Piney Woods, and Southwest Piney Woods Fields whose share of production is being processed through Shell's Thomasville Plant and whose claims exceed the jurisdictional amount of $10,000.00. *Zahn v. International Paper Co.*, 414 U.S. 291, 94 S.Ct. 505, 38 L.Ed.2d 511 (1973); *Snyder v. Harris*, 394 U.S. 332, 89 S.Ct. 1053, 22 L.Ed.2d 319 (1969). The Court ordered that notice be directed to the members of the tentative class informing each of their right to be excluded from this action. Thereafter, a class consisting of seventy-seven (77) members was finally certified by Order dated December 15, 1978.

Trial of this cause was had before the Court without a jury. With apologies to the parties and their attorneys for the inordinate delay in rendering an opinion in this cause, the Court hereby issues and enters the following Findings of Fact and Conclusions of Law pursuant to F. R.Civ.P. Rule 52(a).

FINDINGS OF FACT

As a result of its leasing efforts in the mid-1960's, Shell became the lessee in a substantial number of oil, gas and mineral leases in Rankin and Simpson Counties, Mississippi. After routine geophysical exploration of the area, Shell undertook a drilling program which resulted in the development of the three (3) natural gas fields in Rankin County, Mississippi: Thomasville, Piney Woods and Southwest Piney Woods Fields. It is the production from these fields which is the subject of the instant litigation.

Of thirteen (13) wells drilled in the three (3) fields, the proof indicates that production was being had from the following wells, to wit:

(1) L. D. BURCH # 1, from which production was first had on July 5, 1972, is located in the Thomasville Field on the following described 1280-acre unit:

Section 33, Township 4 North, Range 3 East; and Section 4, Township 3 North, Range 3 East; all in Rankin County, Mississippi.

(2) CRAIN # 1, from which production was first had on August 31, 1972, is located in the Thomasville Field on the following described 1280-acre unit:

Section 32, Township 4 North, Range 3 East; and Section 5, Township 3 North, Range 3 East; all in Rankin County, Mississippi.

(3) GARRETT # 1-R, from which production was first had on March 4, 1978, is located in the Thomasville Field on the drilling unit of the Garrett # 1 well, which was plugged and abandoned after it ceased production on May 11, 1977. The 1280-acre unit for the Garrett # 1-R well is described as follows:

West Half (W ½) of Section 27; Section 28 and East Half (E ½) of Section 27; all in Township 4 North, Range 3 East, Rankin County, Mississippi.

(4) COX-HARPER, from which production was first had on April 9, 1977, is located in the Piney Woods Field as the replacement for the Cox # 2 well. The Cox-Harper is located on the 1280-acre unit originally designated for the Cox # 2:

Sections 21 and 28, Township 3 North, Range 3 East, Rankin County, Mississippi.

(5) RIDGWAY MANAGEMENT # 1-R, from which production was first had on September 1, 1977, is located in the Southwest Piney Woods Field on the 1280-acre

unit originally designated for the Ridgway Management # 1 well. Said unit is described as follows:

> Sections 34 and 35, Township 3 North, Range 2 East, Rankin County, Mississippi.

The named plaintiffs and the class members own royalty interests in the oil, gas and minerals in, on and under the above-described drilling units. The leases and compensatory royalty agreements under which Plaintiffs are compensated for their respective royalty interests are in evidence as Exhibits P-1(a) through P-1(hhhh) and P-2 through P-5.[3] These leases appear on seven (7) different lease forms which are designated in the oil and gas industry as follows:

(1) Paid-up Mississippi Rev. 7/17/45;

(2) Commerical—Form CC-78;

(3) Producers 88-D9803 (Revised 10/1/48) with Pooling Provision;

(4) (Mississippi) Form 0-280 Rev. 3 (8-61) 5M-Producers 88 Rev.;

(5) Producers 88 (9/70)—Paid up with Pooling Provision Mississippi—Alabama—Florida;

(6) Producers 88 (9/70) with Pooling Provision—Mississippi—Alabama—Florida and

(7) Producers 88 Revised—Alabama—Mississippi (11-56).

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3. A list of the leases pooled in each of the five (5) wells appears in evidence as Exhibit P-13. A breakdown of each Plaintiff's fractional royalty interest in each unit and each lease appears in the Title Sheets which are in evidence as Exhibit P-14. A summary of ownership information is provided in Exhibit P-6.

Among the seven (7) lease forms, there are three (3) different gas royalty clauses. Lease forms (1) and (2) above contain the following gas royalty provision, hereinafter referred to as the "Commercial" provision:

> ". . . (b) on gas, including casinghead gas[4] or other gaseous substance[s], produced from said land and sold or *used*, the market value at the well of one-eighth (1/8) of the gas so sold or used, provided that on gas sold at the well the royalty shall be one-eighth (1/8) of the amount realized from such sale[s] . . . ."

Lease forms (3) and (4) above contain the following gas royalty provision, hereinafter referred to as the "Producers 88-D9803" provision:

> ". . . (b) on gas, including casinghead gas or other gaseous substance, produced from said land and sold or used off the premises or in the manufacture of gasoline or other product therefrom, the market value at the well of one-eighth of the gas so sold or used, provided that on gas sold at the wells royalty shall be one-eighth of the amount realized from such sale. . . ."

Lease forms (5), (6) and (7) above contain the following gas royalty provision, hereinafter referred to as the "Producers 88 (9/70)" provision:

> ". . . (b) to pay lessor on gas and casinghead gas produced from said land (1) sold by lessee, one-eighth of the amount realized by lessee, computed at the mouth of the well or (2) when used by lessee off said land or in the manufacture of gasoline or other products, the market value at the mouth of the well, of one-eighth of such gas and casinghead gas. . ."

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4. Brackets indicate variations between lease forms (1) and (2) above.

The natural gas produced from the Thomasville, Piney Woods and Southwest Piney Woods Fields is "sour gas" which is natural gas that is contaminated with chemical impurities, notably hydrogen sulfide. Hydrogen sulfide, or "H_2S",[5] is a highly poisonous compound composed of hydrogen and sulphur. As with other impurities found in a natural gas stream, H_2S must be removed before the gas is of commercial quality. The amount, or concentration, of H_2S in the gas stream commonly determines the procedure used to separate it from the methane gas, the marketable portion of the natural gas stream. Trace quantities of H_2S can be vented into the atmosphere. Where venting presents a hazard or greater quantities of H_2S are present, scrubbers physically separate the H_2S from the methane by absorption. When H_2S is present in the gas stream in significant quantities, it is removed by a chemical process and, where profitable, converted into elemental sulphur, a marketable product. Processing plants, as customarily known in the gas industry, are for treating, sulphur recovery or natural gas liquid recovery. A particular processing plant is designed to accomplish any one or a combination of these functions, depending on the composition of the gas to be processed.

The composite sour gas stream from all wells in the Thomasville, Piney Woods and Southwest Piney Woods Fields contains approximately thirty-five percent (35%) H_2S, eight percent (8%) carbon dioxide and fifty-seven percent (57%) metnane.[6] The Thomasville Plant, as a treating and sulphur recovery facility, removes H_2S from

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5. "H2S" is the denotation used in chemistry to represent the compound hydrogen sulfide.

6. Exhibit No. D-27 contains a chemical breakdown of the production from each of the wells that produces gas processed at the Thomasville Plant.

the raw gas stream, processes it into elemental sulphur, and at the same time produces a dry methane gas from the "sweet" (free of H_2S) gas stream. The plant is located in the West Half (W ½) of Section 27, Township 4 North, Range 3 East, Rankin County, Mississippi, on the designated unit of the Garrett # 1-R well at the end of a gas gathering system which collects raw gas from the Burch # 1, the Cox-Harper and the Ridgway # 1-R. Gas from the Garrett # 1-R and the Crain wells travels by direct pipeline to the plant.

When raw gas arrives at the Thomasville Plant for processing, it contains solutions, such as corrosion inhibitors, which are injected in the gas stream at the well. Removal of these solutions is by a gravity separator, a wide spot in the pipeline, which permits physical separation of the liquid solutions from the natural gas. These solutions are returned to the well site for reuse. The raw gas moves into the sulfinol contactor for the first phase of sulphur removal.

In the sulfinol contactor, which operates under 1000 ppsi (pounds of pressure per square inch), a sulfinol solution is added to the raw gas which causes a chemical reaction resulting in a physical absorption of the H_2S and carbon dioxide by the sulfinol solution. The "sweet" methane gas, containing water, flows from the top of the sulfinol contactor to the glycol contractor. In the glycol contactor, the water is removed from the gas to produce the dry, sweet gas that is marketed.

Meanwhile, the sulfinol solution, bearing the acid gas, flows out the bottom of the sulfinol contactor into the sulfinol still. The reaction that occurred in the contactor is reversed by dropping the pressure in the sulfinol still to 13 ppsi and by adding heat produced by the sulfinol re-

boiler. The sulfinol solution is then recovered and returned to the sulfinol contactor for reuse.

The heated acid gas flows from the sulfinol still to the still overhead condensor where it is cooled. The water vapor produced in the cooling process is returned to the sulfinol contactor. The acid gas passes into the combustion furnace where air is added to oxidize the H_2S into sulphur by the Claus Recovery Process. Such is achieved by three stages of catalytic conversion which produces sulphur in a vapor form. The sulphur is cooled and then stored in pits until sold.

Approximately ninety-seven and one-half percent (97½%) of the H_2S is recovered in the Claus process. The remaining two and one-half percent (2½%) travels to an incinerator stack where it is burned and vented into the atmosphere.

The cost of gas processing and sulphur recovery at the Thomasville Field, together with costs of gathering and transporting[7], are deducted by Shell in calculating payments to royalty interest owners for their respective interests in the subject gas. Similar charges are deducted pro rata from the working interest owners' shares of production. To compute these payments, Shell devised an allocation and accounting procedure which insures that each well is properly credited for its share of the production while reimbursing the plant for costs associated with processing the gas. This latter function is accomplished by equations which compute a "plant-lease split" of the residue gas and sulphur revenues. These equations are designed to accom-

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7. The transportation fee assessed on gas sold to MisCoa is four and one-half (4½) cents per Mcf. This fee reimburses the cost of the forty-mile pipeline from the tailgate of the Thomasville Plant to MisCoa's plant in Yazoo City and the fee of approximately $41,000.00 a month for management of the pipeline paid to Mustang Fuel.

modate such variables as the costs of operating the gas treatment and sulphur recovery facilities, Shell's capital investment, the production rate and revenue received from production, while simultaneously recovering the cost of processing the gas and sulphur.

The equation used to compute the plant-lease split of residue gas is as follows:

$$\frac{\left[\begin{array}{l}\text{(Treating Plant Operating Cost \$/Day)} \\ + \\ \text{(Treating Plant Investment \$)}\left(\frac{\text{Day}}{0.000728}\right)\end{array}\right]\left[\frac{\text{FDP Gross Sales Gas MCF/D Total}}{\text{Plant Inlet MCF/D}}\right] + \text{(Gathering System Investment \$)}\left(\frac{0.000728}{\text{Day}}\right)}{\text{FDP Average Daily Adjusted Net Sales Gas (MCF/D)} \times \text{Average Adjusted Price (\$/MCF)}}$$

The first factor appearing in the numerator of the above expression considers the cost per day of the gas treating plant. Such cost includes not only the actual operating cost of the plant in the form of expenses for payroll, materials, insurance, taxes, etc., but also reimbursement of the capital investment in the treating plant, together with a return on that investment. "Cost" is expressed in the formula by adding the daily operational cost of the treating plant to a recovery factor representing the plant investment multiplied by the daily factor.

The second factor appearing in the numerator of the equation is designed to allocate the cost expressed in the first factor to each well in proportion to its share of the inlet gas. Such is accomplished by dividing a particular

well's field delivery point gross sales gas expressed in Mcf[8] per day by the total plant inlet gas also expressed in Mcf per day. The numerator of the equation, obtained by multiplying the first and second factors, expresses the cost in dollars per day that each well bears for the operation of the treating plant. Where applicable, an additional factor is calculated into the numerator to account for a well's pro rata share of the daily cost of the gathering system.[9] The denominator of the equation expresses the daily revenue to the well in a volume times sales price calculation. Once computed, the equation expresses the fractional share of revenue from production of each well retained by Shell to reimburse the cost of treating the sour gas at its Thomasville Plant.

Shell's sulphur formula,[10] paralleling that for residue gas, is designed to reimburse the plant for cost of sulphur

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8. "Mcf" is defined as "one thousand cubic feet of gas". Williams and Meyers, *Oil and Gas Law*, "Manual of Terms".

9. According to the formula, the gathering system cost recovered is the capital investment of the system, together with a return on that investment. The operating cost of the gathering system is included in the operating cost of the plant.

10. The plant share fraction applied to sulphur revenues is as follows:

$$\frac{\left(\begin{array}{c}\text{Sulphur Plant}\\ \text{(Operating}\\ \text{(Cost \$/Day}\end{array}\right) + \left(\begin{array}{c}\text{Sulphur Plant}\\ \text{(Investment}\\ \text{\$}\end{array}\right) \quad \frac{0.000728}{\text{Day}}}{\text{(Plant Average Sulphur Sales LT/D) (Plant Netback Sulphur Price \$/LT).}}$$

MEANING OF TERMS

Sulphur Plant Operating Cost \$/Day—The daily direct operating cost of the sulphur recovery portion of the Thomasville Plant.

Sulphur Plant Investment \$—The cumulative capital investment in the sulphur recovery portion of the Thomasville Plant.

.000728/Day—A daily capital recovery factor designed to produce a maximum 15% return on investment after tax.

Plant Average Sulphur Sales LT/D—The total daily sulphur sales volume from the Thomasville Plant.

Plant Netback Sulphur Price \$/LT—The net price per long ton of sulphur sales at Thomasville.

recovery out of sulphur revenues. "Cost" is calculated to include operating costs of the sulphur conversion plant as well as a capital recovery factor. Execution of the primary formula computes the plant's share of the total sulphur revenues. Further calculation is necessary to determine each royalty and working interest owner's pro rata contribution to the recovery cost.

The residue gas and the sulphur formulas operate subject to the "Sixty Percent Override Limitation."[11] The Limitation places a ceiling on the amount of revenue returnable to the plant for processing costs. It guarantees that the royalty owners will receive at least forty percent (40%) of their respective share of production without regard to costs incurred in treating the residue gas or in converting the sulphur.

Natural gas processed at the Thomasville Plant is sold under two gas purchase agreements: one, with Mississippi Chemical Corporation and Coastal Chemical Corporation, a partnership, hereinafter referred to as "MisCoa"; the

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11. The Sixty Percent Override Limitation provides as follows:

> "Notwithstanding the application of the above formulae, except the specific conditions hereinafter described, Buyer shall pay Seller on a monthly basis a minimum of forty percent (40%) of the combined revenue from Adjusted Net Sales Gas and Sulphur. This forty percent (40%) minimum shall no longer be effective if, in order to meet requirement under applicable Federal, State or local environmental laws, rules, regulations, standards or policies for continued operation of the Thomasville Plant, either of the following occurs: (i) for any twelve-month period the total operating costs for both the treating sulphur recovery portions of the Plant increase by as much as thirty percent (30%) over the average yearly operating costs experienced during the period beginning January 1, 1973 and ending at the start of such twelve-month period, or (ii) additional capital expenditures of more than $2,500,000 are required for modification of the Plant."

other, with Mississippi Power & Light Company, hereinafter referred to as "MP&L".[12]

The Gas Purchase and Sale Contract with MisCoa was executed by the parties on May 31, 1972, with an effective date of May 22, 1972. This contract provides for an initial base price of fifty-three (53) cents per Mcf of adjusted net sales gas, or processed gas, delivered to MisCoa. After delivery of fifteen million (15,000,000) Mcf of processed gas, the contract provides for an increase in price to fifty-four and fifty-nine hundredths (54.59) cents per Mcf. The contract also provides for fixed price escalation in an amount of three percent (3%) of the base price in effect during the immediately preceding year. At the time of trial, MisCoa was paying sixty-three (63) cents per Mcf for gas. The MisCoa contract provides for a daily maximum of processed gas (46,667 Mcf per day) to be delivered to MisCoa, but there is no requirement for a minimum amount of gas to be delivered. The primary term of the MisCoa contract is thirteen (13) years. Provision is made for an extension of the contract for two (2) consecutive periods of one year each with a year's notice from buyer to seller. Thereafter, the term of the contract continues from year to year until cancelled upon notice by either party. The contract provides for transportation charges of four and one-half (4½) cents per Mcf.

The Gas Purchase and Sale Contract with MP&L is dated, and was executed, on May 23, 1972. This contract is for gas produced in excess of Shell's commitment to MisCoa with a maximum volume of fifteen thousand (15,000) Mcf per day. According to the provisions of the MP&L contract, the base price of the processed gas was forty-five

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12. Shell's contract with MisCoa is in evidence as Exhibit No. P-18(a)-(f). The Mississippi Power & Light contract is Exhibit No. P-19.

(45) cents per Mcf. Price escalation was fixed at one (1) cent per year. The MP&L contract contained an "Area FPC Clause" which provided that if at any time during the contract term, the Federal Power Commission (or any other governmental authority having jurisdiction) prescribed a ceiling rate applicable to comparable gas which was higher than the price then provided to be paid by MP&L, then the price of the subject gas would be increased to equal the higher rate. Also included in the contract was a "favored nations clause" which provided that if, at any time, MP&L paid a higher price for intrastate gas purchased from another producer, then such higher price applied to gas delivered under the terms of the instant contract. Application of the "favored nations clause" was subject to the following limitations:

> "(a) Such higher price must be applicable to a gas reserve or reserves committed to Buyer which does not exceed by more than twenty-five percent (25%) the total volume of residue gas which is estimated to be delivered hereunder to Buyer.
>
> "(b) Such higher price must be applicable to a contract or contracts generally comparable in terms to the terms hereof. In determining comparability the parties shall assign the value to Buyer of such factors as deliverability, variations in daily and annual take obligations, quality pressures, location and other features in such contract or contracts and in this contract, and such values shall be considered in the application of all or part of such higher price to this contract."
>
> "(c) Such higher price shall not be applicable to this contract unless and until Seller has delivered or tendered to Buyer at least fifteen thousand (15,000) Mcf per day of residue gas for a period of sixty (60) con-

secutive days." (Gas Purchase and Sale Contract, May 23, 1972, Article 4, paragraph 4.5, pages 8 through 9).

Shell began its efforts to market the subject gas in mid-1970 at a time when sufficient drilling and testing in the subject fields had revealed the existence of a high pressure sour gas structure in the Smackover formation at a depth of approximately 21,500 feet. In October 1970, after testing of the Garrett # 1 and logging of the Burch, Shell anticipated a flow rate from the subject fields of approximately one hundred thousand (100,000) Mcf per day. At this time, Shell committed itself to building the Thomasville Plant. Prior to completion, Shell contracted for the sale of the gas to be processed therein.

In June 1971, John F. Bruskotter, a twenty-one year veteran in the oil and gas industry, became Shell's manager for natural gas marketing in the Southern region. Such position imbued Bruskotter with full responsibility for negotiating all sales and purchases in the Southern region. According to Bruskotter's testimony, one of Shell's early marketing decisions was whether the subject gas should be committed to the interstate or the intrastate market. Shell considered the interstate market too restrictive since regulation by the Federal Power Commission fixed gas prices according to vintage and region of production. Under FPC regulation, then current discoveries of gas in the subject fields would have been priced at approximately twenty-five (25) cents per Mcf. Shell expected the cost of processing the gas at Thomasville to be twenty-three (23) cents per Mcf, according to then available figures and predictions of future expenditures. An additional concern in submitting the gas to the interstate market was the jurisdiction of the Federal Power Commission in determining the volume, or rate, of production

and in extending gas sales contracts contrary to the designated expiration date.

According to Bruskotter's testimony, prices offered in the intrastate market were generally equal to, or only slightly less than, those found in the interstate market. There were no confinements on the amount of gas that could be produced, consequently, there was a higher present value on production even though the price received in intrastate sales was slightly lower.

These considerations precipitated Shell's decision to commit the subject gas to the intrastate market. Early research by Shell, coordinated with the resources of the Mississippi Research and Development Center, Jackson, Mississippi, revealed that there was no major intrastate market in Mississippi. In June 1971, Shell was negotiating with three (3) potential purchasers: United Gas, MisCoa and MP&L. United's initial offer for an interstate sale at a purchase price of twenty-one (21) cents per Mcf with price escalation every four (4) or five (5) years was rejected with Shell's decision to restrict the subject gas to an intrastate market. Thereafter, United offered forty-two (42) cents per Mcf with one (1) cent price escalation every four (4) years on a commitment of the subject gas to an intrastate pipeline to be built by United. Because United's pipeline system customarily transported gas in interstate commerce, Shell recognized the possibility that the Federal Power Commission might assume jurisdiction of the sale and reduce the ultimate sales price. Consequently, Shell rejected United's offer.

Mississippi Power & Light, considered the largest intrastate consumer of natural gas, was first contacted by Shell in 1969, but serious negotiations did not begin until mid-1971 after MP&L employed Mustang Fuel as its agent

for securing gas supplies. MP&L's best offer, made prior to Shell's acceptance of MisCoa's offer, was forty-five (45) cents per Mcf with one (1) cent per year escalation and an area rate clause. There were, however, no other provisions for price escalation.

MisCoa's offer for the subject gas was fifty-two (52) cents per Mcf with fixed escalation of two percent (2%) per year. MisCoa had a plant-processing capacity of forty-four thousand (44,000) Mcf per day in 1971, and was, at that time, considering enlarging. MisCoa was willing to accept all gas marketed by Shell and, in fact, sought guaranteed delivery of their anticipated needs. Shell, uncertain of the volume of production, was not willing to make such a commitment. MisCoa, as a direct industry user, structured the price for its products on the price it paid for raw materials. Consequently, it was unwilling to include a favored nations clause in the price escalation provision because of the concomitant inability to control the price of its product.

In 1971, fixed escalation provisions were customarily for one percent (1%) or for one and one-half (1½) cents. Shell's goal in negotiations with MisCoa was a price of fifty-four (54) cents per Mcf with two percent (2%) fixed escalation. The compromise ultimately reached was fifty-three (53) cents per Mcf with three percent (3%) fixed escalation and a committed maximum daily delivery of 46,667 Mcf.

Shell's negotiations with MisCoa on price and volume were concluded in July 1971. A letter of intent was signed by the parties in February 1972. Shell considered this contract to be the most advantageous arrangement available to it regarding price, escalation and volume.

In May 1972, Shell concluded negotiations with MP&L for the sale of excess gas at a base price of forty-five (45) cents per Mcf. Figures available at the time of trial indicated that gas delivered to MP&L sold for $1.63 per Mcf. The substantial increase in price paid by MP&L resulted from the invocation of the Federal Power Commission area rate clause in the MP&L contract. At the time of trial, the favored nations provision has never affected pricing of gas sold to MP&L because of the limitation regarding the volume required to be delivered prior to its application.

Under provisions of the sales contracts with both Mis-Coa and Mississippi Power & Light, gas processed at Thomasville is delivered to the respective purchasers at field delivery points, which are part of a metering system on the raw gas stream upstream of the Thomasville Plant. The field delivery points for the Cox-Harper and Ridgway Management # 1-R wells are located on the respective leases and in the immediate vicinity of the respective wells. The field delivery point for the Garrett # 1-R well is located on the unit designated for said well but not on the lease on which the well is located. The field delivery points for the Crain # 1 well and the L. D. Burch # 1 well are located off of the respective units at the inlet to the Thomasville Plant. According to the testimony of Shell's corporate representative, Mr. John McLain, the Crain well is farthest from its designated field delivery point, and it is, "as the crow flies", approximately one (1) mile from the Crain # 1 well to its designated field delivery point.

Shell computes and pays gas royalty to royalty interest owners under the subject units for gas marketed as

well as for gas used as off-lease fuel[13] on "proceeds" from the sales of the subject gas. Shell computes and pays sulphur royalty under the gas royalty provisions of the respective leases on "proceeds" from sulphur sales.[14]

Max Powell, a consulting petroleum engineer from Texas with considerable experience in the industry, testified regarding market value of the subject gas. Powell has been continuously employed in the Texas oil and gas industry in such capacities as engineer for Halliburton Oil Well Cementing Company, hearings officer for the Texas Railroad Commission and chief engineer for Russell Maguire, an independent oil and gas operator. With Maguire, Powell was responsible for all drilling, completion, production and marketing decisions regarding approximately six hundred (600) wells.

As a private consulting petroleum engineer, Powell frequently conducts studies to project the market value of gas and offers his opinion as an expert. To prepare his opinion of the market value of the subject gas, Powell first obtained a map prepared by the Mississippi Oil and Gas Board which identifies state and county boundaries, oil and gas fields in the state, transmission lines and the particular product transmitted therein. The Oil and Gas Board also supplied Powell with a computer printout listing the locations of all fields in the state with a completion

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13. "Off lease" fuel is gas which is produced from one unit but is used to operate facilities on another unit. "On lease" fuel is that part of a unit's production retained by Shell as lessee, to operate lease facilities on the unit at which it is produced. Under the subject leases, as is customarily the case, the lessee is not required to pay royalty on gas used on the unit from which it is produced.

14. From information available at the time of trial, and set out in Exhibit No. D-11, the Douglas Spread Sheets, sulphur royalty was then being computed on $54.27 per long ton.

date of 1971 and later, the names of the pool or reservoir in each field from which production was obtained, the names of the respective operators, well names and numbers, their completion dates and cumulative production of oil, gas and water as of January 1, 1978.

Information regarding prices received by sellers for gas in the identified fields was obtained from the Severance Tax Division of the Mississippi State Tax Division of the Mississippi State Tax Commission. Powell reviewed this information, secured laboratory analysis reports, and prepared "quality-control sheets". The "quality-control sheets" contained information on sales derived from the relevant market area which Powell considered potentially reliable. He initially began his search for market value by defining the relevant market area from which comparable sales would be drawn. Powell's initial search for a relevant market area necessarily encompassed the entire state. The actual market area selected for analysis consisted of seven noncontiguous counties which Powell believed had sufficient numbers of gas sales coming in the market to be representative of current market price. Once potentially relevant sales were isolated, he considered their comparability to the subject gas.

Powell testified that he examined information obtained from the State Oil and Gas Board regarding each sale insofar as its: date or month of first sales under which gas was delivered; location or availability of the field to a market; quantity, or amount of, reserves and its deliverability or the rate at which the reserves were produced and delivered; and quality of gas. Powell concluded that the subject gas should bring a price in the market equivalent to the top price received for gas sold anywhere in the state because, after processing, the subject gas was a superior quality fuel with large reserves and deliverability.

Powell arrived at his opinion of the market value of this gas by arithmetically averaging the top three prices for gas sold in a quarter from what he had designated as the relevant market area between January 1974 and January 1978 (Ex. P-34). Powell admitted that the prices he used were reflective of the net price received for gas from the respective wells and that he did not know whether the gas from the selected wells was marketed under one base contract or under three different contracts. Powell explained that this occurred because prices are reported to the State Tax Commission by well and not by contract. Powell also stated that his opinion of the market value of the subject gas expressed the value of gas as sold and delivered at the tailgate of the Thomasville Plant rather than its market value at the wellhead.

Powell testified that he did not restrict the contracts he relied upon to the relevant time period, 1972 to the present, in order to capture the then-existing market conditions of transactions from other fields which represented new gas coming into the market. His figures failed to account for all gas delivered in January 1974 because that gas was sold pursuant to long term contracts and did not, according to Powell, reflect then current prices. Powell determined that these contracts would not have any impact on a decision concerning present market value of gas. Powell further stated that he did not restrict his contracts to quantities similar to the contracts in question. He believed that since even small quantities of gas command substantial prices, then large reserves and deliverability should obtain at least the same, if not higher, prices.

CONCLUSIONS OF LAW

I

Processing

Owners of royalty interests under producing units in the Thomasville, Piney Woods and Southwest Piney Woods Fields invoked the jurisdiction of this Court pursuant to Section 1 of the Sherman Act and 28 U.S.C. § 1332 to recover alleged insufficiencies in royalty payments. Plaintiffs contend that the formulas utilized by Shell to complete royalty payments wrongfully deduct from royalty's share of production the initial capital investment expended by Shell to construct the Thomasville Plant, a return on that investment, costs of operating the plant, costs of gathering and delivering the raw gas to the plant and costs of transporting the refined product sold to MisCoa in Yazoo City, Mississippi.

Plaintiffs submit that because "royalty" has customarily been defined as "a share of production free of the costs of production", their royalty should be wholly free of any proportionate costs to prepare the subject gas for market. Plaintiffs contend the function performed by the Thomasville Plant is a "production" function and that performance of such is incident to lessee's duty to market,[15] the costs of which are to be borne solely by lessee. According to Plaintiffs, all gas wells ordinarily produce gas which is mixed with salt water and other contaminants which must be separated from the gas stream prior to delivery of the gas to the market. Therefore, Plaintiffs submit that

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15. *See e.g. Gilmore v. Superior Oil Company*, 192 Kan. 462, 388 P.2d 602, 607 (1964); *Warfield Natural Gas Co. v. Allen*, 261 Ky. 840, 88 S.W.2d 989 (1935); *Pan American Petroleum Corp. v. Southland Royalty Co.*, 396 S.W.2d 519 (Tex.Civ. App.1975); Merrill, *Covenants Implied in Oil and Gas Leases* § 85, 214-15 (2ed. 1940).

the Thomasville Plant performs separation and contaminant disposal functions similar to wellhead facilities and is a production, rather than a manufacturing or processing, facility.

Defendant contends that production ceases once the product is extracted from the earth and all costs incurred subsequent thereto in preparing the product for market are processing costs to be borne proportionately by royalty and by working interest owners. Shell concedes that royalty is the landowner's share of production, free of the expenses of production, and that the lessee has the duty to market. Shell recognizes that said duty generally requires a lessee to bear all costs of market research, study, investigation and negotiations with potential purchasers, and further, the costs of certain separators, flowlines, storage tanks and disposal equipment which perform basic "at the well" functions.[16] However, Shell rejects Plaintiffs' contentions that lessee's obligations to produce and market requires lessee to materially enhance the value of a product by processing.[17]

Prior to its operations in the Thomasville area, Shell contends that no producer in the industry had been able to successfully produce a deep, high pressure sour gas well. Shell maintains that the presence of extremely sour gas at great depths, coupled with unprecedented pressures,

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16. *See* Siefkin, George, "Rights of Lessor and Lessee with Respect to Sale of Gas and as to Gas Royalty Provisions", *Southwestern Legal Foundation, Fourth Annual Institute on Oil and Gas Law and Taxation*, 181, 201 (1953).

17. *See*, lease forms entitled "Producers 88 Revised (11-56)" and "Producers 88 (9/70)" provide: "Lessee covenants and agrees to use reasonable diligence to produce, utilize or market the minerals capable of being produced from said wells, but in the exercise of such diligence, *lessee shall not be obligated to install or furnish facilities other than well facilities* and ordinary lease facilities of flowlines, separator, and lease tank. . . ." (emphasis added).

created an entirely novel situation for an industry which had not successfully produced high pressure hydrogen sulfide gas. According to Shell, the raw gas stream produced contains large amounts of hydrogen sulfide requiring that the gas be processed to obtain a marketable product. Shell believed that the wellhead value of the produced gas could be substantially increased by construction of a processing plant. Therefore in 1970, despite the inability to predict volume and continuity of production, and the unavailability of a third party willing to assume responsibility for construction and operation of a processing plant absent a guaranteed volume, Shell undertook to design and erect a plant in order that the subject gas could be produced.

Shell contends that the plant-lease split adequately compensates royalty owners for their share of production even though it recoups direct operating costs, cost of plant capital investment, and, where applicable, gathering costs incurred in bringing gas to the plant because these costs were necessary to convert worthless gas and to recover sulphur in commercial quantities from the sour gas stream. In essence, Shell contends that production of the subject gas ceases once the raw gas is extracted from the earth and that costs incurred thereafter in preparing the commodity for market are to be borne proportionately by royalty and by working interest owners. In support of its argument, Shell relies on the language contained in the leases which provides that Shell's royalty obligation is based on the value of the raw gas "at the well".[18]

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18. Each of the subject royalty provisions contains language to the effect that when royalty is computed on the basis of market value, such computations are of value "at the well" or "at the mouth of the well".

[1-3] Royalty is defined in Mississippi as "a share of the production or profits reserved by the owner for permitting another to use or develop his property".[19] The working interest is distinguished from royalty in that royalty: (1) is a share of production free of any costs of discovery and production with (2) no right to do any act or thing to discover and produce the oil and gas.[20] The working interest in minerals, the primary developer, on the other hand, is: (1) responsible for costs of discovery and production in addition to being (2) given the right to discover and produce oil and gas.[21] Indeed, in the oil and gas industry,

> ". . . it is common knowledge that the landowner does not, and usually could not, himself provide the money, therefore, the usual and almost universal method for finding oil and bringing it to the surface being for the landowner to authorize a person or corporation engaged in such business to find the oil and bring it to the surface approximating all that he produces thereby to himself except an agreed portion thereof reserved by and to be delivered, or its value paid, to the landowner and usually designated as royalty . . . ."[22]

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19. *See* e.g., *Texaco, Inc. v. Pigott*, 235 F.Supp. 458, 464 (S.D.Miss.1964), *aff'd*, 358 F.2d 723 (5th Cir. 1966) (per curiam); *Mounger v. Pittman*, 235 Miss. 85, 108 So.2d 565, 566 (1959); *Palmer v. Crews*, 203 Miss. 806, 35 So.2d 430, 435 (1948).

20. *Texaco, Inc. v. Pigott*, 235 F.Supp. 458, 464 (S.D.Miss. 1964), *aff'd*, 358 F.2d 723 (5th Cir. 1966) (per curiam); *Mounger v. Pittman*, 235 Miss. 85, 108 So.2d 565, 566 (1959); *Palmer v. Crews*, 203 Miss. 806, 35 So.2d 430, 435 (1948).

21. *See* note 19 *supra*.

22. *Gulf Refining Co. v. Stanford*, 202 Miss. 602, 30 So.2d 516, 517 (1947).

The United States Supreme Court in *Federal Power Commission v. Panhandle Eastern Pipe Line Co.*, 337 U.S. 498, 518, 69 S.Ct. 1251, 1262, 93 L.Ed. 1499 (1949) concluded that the "natural and clear" meaning attributable to "production" of gas is "the act of bringing forth gas from the earth".[23] Costs attributable to production have been defined as "expenses incurred by the lessee in exploring for mineral substances and in bringing such substances to the surface".[24] These expenses include "costs of geophysical surveys; drilling costs; tangible and intangible costs incurred in testing, completing or reworking a well, includ- the cost of installing a Christmas tree".[25]

[4] Royalty is customarily subject to a proportionate share of the costs incurred subsequent to production where, as is usually the case, the royalty, or non-operating interest, is payable "at the well".[26] Among these costs borne by non-operating interests are: (1) gross production and severance taxes; (2) transportation charges or other expenses incurred in transporting the minerals produced from the wellhead to the place where the buyer takes possession thereof; (3) expenses of treatment required to make the mineral product salable, e.g., expenses of dehydration; (4) expenses of compressing gas to make it deliverable into a purchaser's pipeline; and (5) manufacturing costs incurred in extracting liquids from gas or casinghead gas,

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23. *See also, Interstate Gas Co. v. EPC*, 331 U.S. 682, 689-91, 67 S.Ct. 1482, 1486-87, 91 L.Ed. 1742 (1947); *Colorado Interstate Gas Co. v. FPC*, 324 U.S. 581, 597-604, 65 S.Ct. 829, 837-840, 89 L.Ed. 1206 (1945).

24. 3 Williams, *Oil and Gas* § 645, pp. 591-93 (1977), Aultman, Richard, Kindberg, Charles, "Oil and Gas: Non-operating Interests Liability" 25 *Okla. Law Review* 363, 369-76 (1972).

25. *See* Williams, note 24 *supra* at 591-93.

26. *Id. See also*, Aultman, note 24, *supra* at 369-76.

viz., costs incurred in adding value to the wellhead product.[27]

[5, 6] Plaintiffs contend that the Thomasville Plant performs a production function. Plaintiffs present this contention to the Court as a novel issue. The Court, however, finds abundant precedent in the Fifth Circuit and elsewhere to support its conclusion that production ceases once the product is extracted from the earth. The Court finds and concludes that the function performed by the Thomasville Plant is subsequent to production and is a processing function whereby large expenditures are made to convert a "valueless commodity into one of greater value". *Freeland v. Sun Oil*, 277 F.2d 154, 158 (5th Cir. 1960). As succinctly stated by the Fifth Circuit in *Freeland*, ". . . costs which are essential to make a commodity worth anything or worth more must be borne proportionately by those who benefit." Consequently, royalty is obligated to contribute proportionately to the costs of processing the product.

The court in *Freeland* considered whether Louisiana law[28] required a lessor to share proportionately in the costs

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27. *Id. See also, Holbein v. Austral Oil Co., Inc.* 609 F.2d 206, 209 (5th Cir. 1980) (per curiam).

28. Although Louisiana law was applied in *Freeland*, the court stated that the solution to the problem of determining royalty was to be found in the lease contract. 277 F.2d at 157. The gas royalty clause considered, identical to Producers 88-D9803 in controversy in the case *sub judice*, provides:

> "The royalties to be paid by Lessee are: . . . (b) on gas, including casinghead gas or other gaseous substance, produced from said land and (1) *sold or used off the premises* or in the manufacture of gasoline or other products therefrom, *the market value at the well of one-eighth of the gas so sold or used, provided that on (2) gas sold at the wells the royalty shall be one-eighth of the amount realized from such sale. . . .*" *Id.* (emphasis added).

(Continued on following page)

of a gas extraction process whereby gas was "stripped of recoverable fluids" and converted into a merchantable product. The liquid content of the gas was not separated on the leased premises. Rather it was carried with the full gas stream to a processing plant where the gas was subjected to separation, absorption and dehydration processes. The processing plant in this case was not owned and operated by the lessee. The processor retained, under the processing contract, a certain percentage of the end product as compensation for construction and operating costs. The balance was returned to the lessee-oil companies which paid one-eighth royalty computed thereon. Royalty challenged the percentage retained by the third party processor.

The record in *Freeland*, as in the case *sub judice*, established that gas at the wellhead had little marketability and no demonstrated market value. In order to enhance the value of the gas, it was necessary to process it through an expensive gasoline extraction plant. The court concluded that royalty was subject to a proportionate share of processing costs because "the availability of the extracting process and its application had enhanced the value of the product". The court undertook a thorough analysis of Louisiana law to determine the gas valuation from which royalty would be computed. The court concluded that:

> "[t]he contract would be harsh unless the costs were shared . . . all increase in the ultimate sales value attributable to the expenses incurred in transporting and

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Footnote continued—

See also, pages 4-5 *supra* for lease provisions in evidence. The court interpreted the plain meaning of the contract to that on gas sold or used off the premises, market value is the "market value at the well." This conclusion supports Shell's contention that royalty must be based on wellhead value. *See also, Holbein v. Austral Oil Co., Inc.*, 609 F.2d 206, 209 (5th Cir. 1980) (per curiam).

> processing the commodity must be deducted. The royalty owner shares only in what is left over. . . . In this sense, he bears his proportionate part of that cost. . . ."[29]

[7] Plaintiffs seek to shield themselves from costs of materially enhancing the value of the subject gas by maintaining that this function is to be performed by Shell pursuant to its duty to market the product. Plaintiffs' contention lies in the theory that the Thomasville Plant is necessary to "produce" merchantable gas and that "production" cannot be realized without the plant and pipeline facilities. Therefore, these facilities must be labeled "production" facilities for which royalty bears no cost. However, Plaintiffs offer no authority for their contention. The Court believes that Plaintiffs would have difficulty supporting same, as, not unexpectedly, the judiciary overwhelmingly endorses the industry practice of royalty sharing in costs incurred by the lessee in processing and trans-

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29. 277 F.2d at 158-59. *See Scott Paper Co. v. Taslog, Inc.*, 638 F.2d 790, 799 (5th Cir. 1981) (court approved method of determining value of gas by deducting from sales revenue the costs of the transmission, processing and a reasonable return on investment); *Holbein v. Austral Oil Co., Inc.*, 609 F.2d 206, 209 (5th Cir. 1980) (per curiam) (royalty shares proportionately in costs subsequent to production); *Ashland Oil, Inc. v. Phillips Petroleum Co.*, 554 F.2d 381, 384 (10th Cir. 1977) (en banc) (third party processor has the right to recover a return on its investment); *Barby v. Caboe Corp.*, 465 F.2d 11, 15 (10th Cir. 1972) (royalty was precluded from contending an entitlement to royalties on the end product after extraction); *Cameron v. Stephenson*, 379 F.2d 953, 956 (10th Cir. 1967) (royalty must bear its share of transportation costs); *Phillips Petroleum Co. v. Record*, 146 F.2d 485 (5th Cir. 1944) (attempt by lessor to base royalty on value of products manufactured rather than on value of gas itself "will not do at all"); *Kretni Development Co. v. Consolidated Oil Corp.*, 74 F.2d 497, 500 (10th Cir. 1934), *cert. denied*, 295 U.S. 750, 55 S.Ct. 829, 79 L.Ed. 1694 (1935) (lessee's duty to market gas does not extend to providing ninety miles of pipeline facilities); *Armstrong v. Skelly Oil Co.*, 55 F.2d 1066 (5th Cir. 1932) (lessee-operator of a gasoline extracting plant is entitled to recover a fair return on his investment).

porting gas in fulfillment of its marketing responsibilities.[30] Even though the lessee may be under a duty, express or implied, to market production, this duty does not require an assumption of all costs.

Plaintiffs cite two Kansas cases in support of their position: *Schupbach v. Continental Oil*, 193 Kan. 401, 394 P.2d 1 (1974); *Gilmore v. Superior Oil Co.*, 192 Kan. 388, 388 P.2d 602 (1964). In *Gilmore*, the Kansas Supreme Court ruled that the lessee has a duty to pay for gas compression expenses necessary to make gas marketable and that those expenses could not be passed on to royalty. The court reasoned as follows:

> "[i]f it is the lessee's obligation to market the product, it seems necessarily to follow that his is the task also to prepare it for market, if it is unmerchantable in its natural form. No part of the costs of marketing or of preparation for sale is chargeable to the lessor." 388 P.2d at 607.

The court reached a similar conclusion in *Schubach*. However, such results conflict with the finding by the Kansas Supreme Court in *Matzen v. Hugoton Products Co.*, 182 Kan. 456, 321 P.2d 576 (1958), where the court held that proper chargeable operating expenses, including gathering, processing and dehydrating, must be deducted to calculate the value of gas "at the wellhead".

[8] The authority relied upon by Plaintiffs is unconvincing, apparently in conflict with prior authority and certainly not binding on this Court. This Court finds that Plaintiff's position is unduly harsh and totally untenable and that the only equitable conclusion is to hold that lessor and lessee shall bear proportionately costs of materially

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30. *See* note 27 *supra*.

enhancing the value of the subject gas. As stated in *Freeland,*

> ". . . costs essential to make a commodity worth anything or worth more must be borne proportionately by those who benefit." 277 F.2d at 159.

II

Marketing

Plaintiffs contend that Shell's failure to procure a price redetermination clause in the MisCoa contract was a breach of Shell's implied duty as lessee to market. This breach, according to Plaintiffs, entitles them to royalty based upon market value regardless of lease provisions which require that gas royalty be paid on the "amount realized" by lessee.

In support of their position, Plaintiffs refer to Shell interoffice communications[31] which Plaintiffs contend reflect Shell's awareness that prices for natural gas would increase. Plaintiffs contend that such awareness required Shell to negotiate appropriate terms in the MisCoa contract. In the absence of such action, Plaintiffs submit they are entitled to more protection than that provided under an "amount realized" royalty provision.[32]

Shell ardently opposes Plaintiffs' position. Shell contends that at all times it fulfilled its duty to market as a reasonably prudent operator by exercising "due care" and "reasonable diligence" in investigating and procuring buyers for the subject gas. According to Shell, in the

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31. *See* Exhibit P-63.

32. *Craig v. Champlin Petroleum Co.*, 300 F.Supp. 119 (W.D.Okl.1969), *aff'd*, 421 F.2d 236 (10th Cir. 1970); *Amoco Production Co. v. First Baptist Church of Pyote*, 579 S.W.2d 280 (Tex.Civ.App.1979).

absence of proof of failure by lessee to market gas with the diligence of a reasonable prudent operator, there are no judicial decisions requiring that payment of royalty under "amount realized" royalty provisions be based upon any standard other than the amount actually realized by the lessee.

[9-11] Because of a lessee's exclusive control over the production and development of oil and gas, the law imposes upon the lessee certain implied covenants; namely to reasonably develop, produce, operate and market production.[33] A lessee, bound by implied obligations, is held to the standard of conduct, in Mississippi, of the "prudent operator".[34] The test for his performance generally applied is whether or not the lessee has used due care and diligence.[35] Due care and diligence is defined as that care and diligence which would be exercised in a particular situation with due regard to the interests of both lessor and lessee.[36] Furthermore, reasonable diligence on the part of

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33. *Weymouth v. Colorado Interstate Gas Co.*, 367 F.2d 84, 93 (5th Cir. 1966); *Waechter v. Amoco Production Co.*, 217 Kan. 489, 537 P.2d 228 (1975).

34. *Southwest Gas Producing Co. v. Seale*, 191 So.2d 115, 119-20 (Miss.1966).

35. *See, e.g., Weymouth v. Colorado Interstate Gas Co.*, 367 F.2d 84, 93 (5th Cir. 1966); *Newell v. Phillips Petroleum Co.*, 144 F.2d 338 (Okl.1944); *Foster v. Atlantic Refining Co.*, 329 F.2d 485, 489 (5th Cir. 1964); *Craig v. Champlin Petroleum Co.*, 300 F.Supp. 119 (W.D.Okl.1969), *aff'd*, 421 F.2d 236 (10th Cir. 1970); *Nordan-Lawton Oil & Gas Corp. of Texas v. Miller*, 272 F.Supp. 125, 135 (W.D.La.1967); *Harding v. Cameron*, 220 F.Supp. 466, 470 (W.D.Okl.1963); 2 Summers, *The Law of Oil & Gas* § 400 (1959).

36. *Craig v. Champlin Petroleum Co.*, 300 F.Supp. 119 (W.D.Okl.1969), *aff'd*, 421 F.2d 236 (10th Cir. 1979); *Nordan-Lawton Oil & Gas Corp. of Texas v. Miller*, 272 F.Supp. 125, 135 (W.D.La.1967); *Harding v. Cameron*, 220 F.Supp. 466, 470 (W.D.Okl.1963); *Amoco Production Co. v. First Baptist Church of Pyote*, 579 S.W.2d 280 (Tex.Civ.App.1979); *Southwest Gas Producing Co. v. Seale*, 191 So.2d 115, 119-20 (Miss.1966).

the lessee must conform to, and be governed by, what is expected of persons of ordinary prudence in the industry under similar circumstances, conditions, practices and procedures.[37] Among the facts and circumstances which are to be considered in determination of the lessee's diligence in marketing the gas are: availability of marketing facilities, i.e., presence of pipelines and efforts of the lessee in securing extensions of pipelines into the field; pressure and quality of gas as affecting its marketability; amount produced; prevailing market price and time and manner of the performance of such acts as might result in marketing.[38] What constitutes reasonable time and due diligence depends on the particular facts.

In support of their proposition that a lessee has an implied duty to market natural gas at a current market value under a lease provision basing royalty on the amount realized from the sale of such gas, Plaintiffs cite *Amoco Production Co. v. First Baptist Church of Pyote*, 579 S.W. 2d 280 (Tex.Civ.App.1979). The dispute in *Amoco* concerned eighteen (18) oil and gas leases, each of which provided that on gas sold at the wells the royalty would be one-eighth (⅛) of the amount realized from such sale. The working interests owners had been selling gas to one of four different purchasers, each of whom had its own gas pipeline connected to the well. The several owners of the oil and gas leasehold estates in the tracts of land pooled same to form another unit containing 640 acres. The question confronted by the Texas court was whether Amoco had breached any legal duty when approximately twenty months after the new unit began producing gas,

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37. *Nordan-Lawton Oil & Gas Corp. of Texas v. Miller*, 272 F.Supp. 125, 135 (W.D.La.1967); 2 Summers, *The Law of Oil & Gas* §§ 400, 415 (1959).

38. 2 Summers at § 415.

it committed and dedicated such gas to a long term contract on terms providing one-half (½) of the amount at which gas was then being sold to other purchasers from the same well and with no right for future price redetermination based on market increases, and while doing so obtained for itself extra benefits in respect to other properties in which the lessors had no interest.

The court concluded that Amoco, by dedicating additional leases in June 1975, obtained an increased price for gas already dedicated under a prior contract from seventeen (17) cents per Mcf to seventy (70) cents per Mcf. Although this increase represented a substantial benefit for both parties, it also meant that on some leases, royalty owners would receive gas royalty payments which were one-half (½) the original price with limited provisions for future accelerations. Therefore, the court concluded that the lessees had breached their implied covenant to market natural gas at a fair market value under a lease providing for royalty based on amount realized. The court reasoned that the breach committed by Amoco was its failure to secure the highest price reasonably obtainable. Therefore, in deciding the issue of whether there exists a duty to market the gas "at any particular price, particularly when the lease provided for royalty based on the 'amount realized' from such sale", the court determined that the lessee's duty is to secure the highest price reasonably obtainable. The court's determination that the lessee must procure the highest price obtainable does not, as Plaintiffs contend, entitle lessors to royalty computed on market value under an "amount realized" gas royalty provision.

Plaintiffs further submit that *Craig v. Champlin Petroleum Co.*, 300 F.Supp. 119 (W.D.Okl.1969), *aff'd*, 421 F.2d 236 (10th Cir. 1970), supports their position that the les-

see's duty to market the gas entitles the lessors to current market value for such gas. The trial court in *Craig*, however, specifically found that Champlin Petroleum "made absolutely no effort to find a market for the gas" although a viable market was available and that "had it not been for Champlin's failure, or its refusal, to seek out a market for the gas . . ., a market could have easily been found."[39] Therefore, the court concluded that Champlin failed to exercise due diligence in marketing the gas; thereby breaching its duty. Upon such finding, the court held that lessors were entitled to recover the prevailing market price under lease clauses providing for payment to lessors of "the prevailing market price for gas".

[12] The Court finds neither *Amoco* nor *Craig* applicable to the issue of Shell's alleged failure to fulfill its obligation to market the gas. Indeed, this Court concludes upon a review of its findings, that Shell fulfilled its implied obligation to market the gas as a reasonable prudent operator in the exercise of due care and diligence. Specifically, Shell's failure to procure a price renegotiation clause in the MisCoa contract was not a breach of its implied duty to market.

Shell commenced its search for a viable market in 1969 upon discovery of gas in the Thomasville Field. Two years of intense market research of potential purchasers was undertaken to secure a buyer for the large volume of gas anticipated. At the time the MisCoa contract was negotiated in 1971, gas was customarily being sold under long-term contracts for terms up to twenty (20) years at fixed prices with minimal fixed price escalation clauses. Indefinite pricing clauses were not commonly obtainable in 1971-1972. Of several potential purchasers, Shell nar-

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39. 300 F.Supp. at 122, 124.

rowed its alternatives to United Gas Pipeline Company, Mississippi Power & Light Company (MP&L) and Mississippi Chemical Company (MisCoa). United's best offer was rejected early and in June 1971, Shell notified MP&L that its offer for the primary gas sale was not competitive. In that same month, Shell accepted MisCoa's offer in the amount of fifty-three (53) cents per Mcf delivered at Yazoo City, Mississippi, escalating three percent (3%) per year after delivery of fifteen million (15,000,000) Mcf. The final contract with MisCoa was signed May 22, 1972. In December 1971, MP&L offered to purchase the excess gas over and above that purchased by MisCoa at forty-five (45) cents per Mcf escalating at one (1) cent per Mcf per year. The final contract with MP&L was signed May 23, 1972 with the addition of a favored nations clause. If Shell had committed the gas to the interstate market, the sales price would have been approximately twenty-five (25) cents per Mcf. The prices received under the MisCoa contract were the best obtainable and the highest known for any gas sale in the United States at the time the contract was executed.

III

Point of Sale

Plaintiffs contend that royalty owners whose leases with Shell contain the Commercial or the Producers 88-D9803 provisions are entitled to royalty computed on "market value" of the subject gas because it is being sold off of the respective lease premises. According to Plaintiffs, gas is ordinarily "sold" where it is measured and delivered. Plaintiffs assert that the purchasers of the subject gas do not have pipelines or other facilities connected to the field delivery points where Defendant maintains the subject gas is measured and delivered. Additionally, Plaintiffs

contend that the sales of gas should not be measured at the designated field delivery points because, at those points, hydrogen sulfide and other contaminants are still mixed with the methane. Contract specifications regarding quality and quantity of gas are not met until the gas is metered in Yazoo City. Further, Shell retains total and exclusive custody and control of the gas, assuming risk for loss, until it reaches Yazoo City, Mississippi. Therefore, according to Plaintiffs, the actual point of sale for the MisCoa gas would be Yazoo City, Mississippi.

Defendant counters Plaintiffs' argument by referring to the gas sales contracts which designate the field delivery points as the points of sale for the subject gas. Defendant contends that the provisions of the sales contract designating points of sale are controlling because the point of sale for personal property is determined by the intentions of the parties as embodied in the sale contract itself. According to Defendant, title to the subject gas passes at the field delivery points, or the points in the respective fields where the gas is "initially measured, sold and delivered" pursuant to provisions of the sales contract.[40] Furthermore, Defendant submits that Miss.Code Ann. § 75-2-106(1) (1972) provides that a "sale" consists of title passing from seller to buyer for a price. Shell maintains that it sold the entire raw gas stream at the respective field delivery points and that title to same passed at those points even though Shell contractually reserved the right and assumed the obligation to process the gas and to redeliver it. According to Defendant, custom and practice within the oil and gas industry recognizes this procedure.[41] The Court

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40. See Exhibits P-18(a) §§ 6.1, 1.1(i); P-19 §§ 6.1, 1.1(g).

41. *See e.g., Barby v. Cabot Corp.*, 465 F.2d 11 (10th Cir. 1972); *Waechter v. Amoco Production Co.*, 217 Kan. 489, 537 P.2d 228 (1975); *Stanolind Oil & Gas Co. v. Cities Service Gas Co.*, 178 Kan. 202, 284 P.2d 608 (1955).

considers the cases cited by the parties to be enlightening; it, however, believes that the Uniform Commercial Code controls this issue.[42]

Miss.Code Ann. Section 75-2-107(1) (Supp.1980) provides that "a contract for the sale of minerals or the like (including oil and gas) . . . is a contract for the sale of goods within this chapter. . . ."

Section 75-2-401(1) provides:

> "[t]itle to goods cannot pass under a contract for sale prior to their identification to the contract. . . . Subject to these provisions and to the provisions of the chapter on Secured Transactions (Chapter 9), *title to goods passes from the seller to the buyer in any manner and on any conditions explicitly agreed to by the parties.*" (emphasis added).

Section 75-2-401(2) continues by providing that "[u]nless otherwise explicitly agreed title passes to the buyer at the time and place at which the seller completes his performance with reference to the physical delivery of the goods. . . ."[43]

[13, 14] Furthermore, Miss.Code Ann. Section 75-2-501(1) (1972) states:

> "the buyer obtains a special property and an insurable interest in goods by identification of existing goods as goods to which the contract refers even though the goods so identified are *nonconforming* and he has an

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42. Miss.Code Ann. §§ 75-1-101—11-108 (1972), particularly Miss.Code Ann. §§ 75-2-101—725 (1972).

43. The Uniform Sales Act (Codes 1942, § 41A:2-105; Laws, 1966, Ch. 316 § 2-105, eff. Mar. 31, 1968) provided that if the contract for sale allowed the buyer an opportunity to inspect and reject the goods once delivered, then title did not pass until the buyer had a reasonable opportunity to inspect.

> option to return or reject them. Such identification can be made at any time and in any manner explicitly agreed to by the parties."

Moreover, Miss.Code Ann. Section 75-2-105(4) (1972) provides:

> "an undivided share in an identified bulk of fungible goods is sufficiently identified to be sold although the quantity of the bulk is not determined. Any agreed proportion of such a bulk or any quantity thereof agreed upon by number, weight or other measure may to the extent of the seller's interest in the bulk be sold to the buyer who then becomes an owner in common."

Therefore, this Court concludes that the gas sales contracts which designate the field delivery points as the points of sale for the subject gas embody the true intentions of the parties and are controlling. Accordingly, under the provisions of the MisCoa contract, sales of the gas produced at the Ridgway # 1-R and the Cox-Harper wells occur on the lease on which the well is located; the sales of gas from the Garrett # 1-R well, on the designated unit; and, for the Crain # 1 and L. D. Burch # 1 wells, at respective field delivery points located near the inlet of the Thomasville Plant.

[15] The Commercial provision requires that royalty be computed on market value for gas "sold or used . . . provided that on gas sold at the well the royalty shall be one-eighth (⅛) of the amount realized. . . ." The Producers 88-D9803 requires that royalty on gas "sold or used off the premises . . . be paid on the market value . . . of the gas so sold or used, provided that on gas sold at the wells royalty be computed on amount realized from such sale. . . ." Under the former clause, royalty owners are

entitled to be paid for their share of production sold computed on market value of all gas *sold or used*, unless the sale of such gas occurs at the well. Under the latter clause, royalty is entitled to their share of production computed on market value where the gas is sold or used *off the premises*, subject again to the condition that royalty be computed on amount realized when the gas is sold at the well.

[16] The threshold question in the resolution of the instant issue necessarily becomes whether the sales of the subject gas occur "at the well". The points of sale of the subject gas, the respective field delivery points, are located upstream of the Thomasville Plant at points where the respective raw gas streams are metered prior to said gas' being commingled and processed. Thus, under the provisions of the sales contract, the subject gas is being sold in its raw form, subject to terms of the contract which provide for its redelivery to Shell for processing. Despite the variance in distances of field delivery points from the Christmas trees of the respective wells, this Court finds that such sales were made "at the well". The Court reasons that the location of the field delivery points for the Garrett # 1-R, Crain # 1 and L. D. Burch # 1 wells is off of their respective leases, and in the case of the Crain and Burch wells, their respective designated units, is insignificant as the use of "off the premises" and "at the well" in the Producers 88-D9803 does not describe circumstances intended to be mutually exclusive. Consequently, the Court concludes that royalty owners should be compensated for their share of production sold under the subject contracts based on the amount realized from such sales. Under each of the subject royalty provisions, royalty on gas "used" by Shell off the land or premises is to be computed on market value "at the well" or "at the mouth of the

well". Testimony at trial indicated that Shell uses "amount realized" as the basis on which it computes payments to royalty owners for "off-lease" fuel. Under such circumstances, all royalty owners are clearly entitled to royalty computed on the market value of gas so used.

IV

Market Value

Having concluded that Plaintiffs are entitled to receive royalty computed on "market value" for off-lease fuel used by Shell, the Court is called upon to define "market value" as it appears in the subject gas royalty clauses. Plaintiffs contend that royalty is entitled to market value prevailing at the time the gas is produced, sold and delivered. In support of its argument, Plaintiffs cite the Court to a plethora of cases from various jurisdictions which construe "market value" as current market value rather than the initial contract price.

Defendant counters Plaintiffs' theory of market value by alerting the Court to the realities of the oil and gas industry. According to Shell, market value cannot be determined without considering the manner in which a commodity is sold. In this case, Defendant contends the proof clearly established that in 1971 and 1972 natural gas was customarily sold under long-term contracts which did not contain provisions for price redetermination, i.e. favored nations clauses. Purchasers sought irrevocable commitments for terms averaging twenty (20) years to ensure a continuous supply of gas. Thus, Defendant submits, the proceeds derived from the sale of gas were permanently established for the term of the contract upon its execution. Although the gas royalty provisions in the subject leases do not define "market value", Defendant maintains that

it must necessarily be determined as of the date of execution of the contract.

A determination of the instant issue requires an in-depth analysis of the available legal precedents. Any such analysis must commence with the well-known case of *Texas Oil & Gas Corp. v. Vela*, 405 S.W.2d 68 (Tex.Civ. App.1966), *rev'd in part and aff'd in part*, 429 S.W.2d 866 (Tex.1968). Although not the first case in which a court considered the issue of current market value versus contract price, *Vela* is the most definitive authority on the subject. In *Vela*, royalty sought to recover alleged deficiencies in royalty payments made pursuant to the provisions of the 1933 oil, gas and mineral lease which required the lessee to pay to lessor:

> ". . . as royalty for gas from each well where gas only is found, while the same is being sold or used off the premises, one-eighth of the market price at the wells of the amount so sold or used."

Plaintiffs sought to define "market price" as the current market value of the gas.[44] The defendant argued that "market price" was the price contracted for in good faith by the lessee pursuant to its duty to market.

The Texas court determined as follows:

> ". . . the parties knew how to and did provide for royalties payable in kind, based upon market price or market value, and based upon the proceeds derived by the lessee from the sale of gas. They might have agreed that the royalty on gas produced from a gas well would be a fractional part of the amount realized by

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44. Pursuant to the contract, royalty owners agreed to a price of 2.3 cents per Mcf. Plaintiffs instituted suit to recover alleged deficiencies predicated on a 13.047 cents per Mcf current market price. 429 S.W.2d at 869.

> the lessee from its sale. Instead of doing so, however, they stipulated in plain terms that the lessee would pay one-eighth of the market price at the well of all gas sold or used off the premises. *This clearly means the prevailing market price at the time of the sale or use. The gas which was marketed under the long-term contract in this case was not 'being sold' at the time the contracts were made but at the time of delivery to the purchaser.* [citation omitted]." (emphasis added).[45]

Therefore, the court concluded that the contract price was not necessarily the market price within the meaning of the royalty provision even though such interpretation would prove financially burdensome to a lessee who has made a long-term contract without protection against price increases. The court found support for its conclusions in *Foster v. Atlantic Refining Co.*, 329 F.2d 485 (5th Cir. 1964); *Wall v. United Gas Public Service Co.*, 178 La. 908, 152 So. 561 (1934) and *Martin v. Amis*, 288 S.W. 431 (Tex. 1926). In *Martin v. Amis*, the Supreme Court of Texas concluded that a contract for the sale of gas is an executory contract which is effected only upon delivery of the product to the purchaser.[46]

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45. 429 S.W.2.d at 871. *See also, J. M. Huber v. Denman*, 367 F.2d 104, 109 (5th Cir. 1966) (market value not synonymous with actual proceeds); *Weymouth v. Colorado Interstate Gas Co.*, 367 F.2d 84 (5th Cir. 1966) (same); *Lightcap v. Mobil Oil Corp.*, 221 Kan. 448, 562 P.2d 1, 2, 5 (1977) (same).

46. 288 S.W. at 433. *Accord, Foster v. Atlantic Refining Co.*, 329 F.2d 485, 489 (5th Cir. 1964); *Kingery v. Continental Oil Co.*, 434 F.Supp. 349, 352, 354 (W.D.Tex.1977), *rev'd*, 626 F.2d 1261 (5th Cir. 1980); *Exxon Corp. v. Jefferson Land Co., Inc.*, 573 S.W.2d 829, 832 (Tex.Civ.App.1970); *Exxon Corp. v. Middleton*, 571 S.W.2d 349, 354 (Tex.Civ.App.1978), *rev'd*, 613 S.W.2d 240 (Tex.1981); *Butler v. Exxon Corp.*, 559 S.W.2d 410, 416 (Tex.Civ.App.1977). *See also, J. M. Huber Corp. v. Denman*, 367 F.2d 104, 113-14 (5th Cir. 1966).

In *Wall v. United Gas Public Service Co.*, the Louisiana Supreme Court concluded that market price is the actual price at which a given commodity is currently sold. The court reasoned that prior to the moment the gas reached the surface, neither party owned anything other than the right to explore and reduce the gas to possession. Thereafter, the parties are vested with proportionate ownerships. Their proportionate share is to be determined according to the value of gas as fixed by market price at the time title vests.[47]

In *Foster v. Atlantic Refining Co.*, the Fifth Circuit considered the current market value—contract price dichotomy. The plaintiff in *Foster* sued to recover alleged deficiencies in royalty payments based upon the royalty provision which stated as follows:

> ". . . [t]he conventional royalties to be paid by Lessor are: (a) on oil and gas, including all hydrocarbons, one-eighth of that produced and saved from said land, the same to be delivered to the credit of the Lessor into the pipeline and to be sold at the market price therefor prevailing for the field where produced when run."

The lessee entered a twenty-year contract in 1950 with an escalation of one percent (1%) every five years. The evidence in the case established that the price prevailing in the field was thirteen (13) cents in 1957 and fourteen (14) cents in 1958-62. During that same period, the lessee was receiving eight to nine (8-9) cents. The lessee advanced the argument that at the time it executed the 1950

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47. *See Montana Power Co. v. Kravik*, 586 P.2d 298, 302 (Mont.1978); *Exxon Corp. v. Middleton*, 571 S.W.2d 349, 354 (Tex.Civ.App.1978), *rev'd*, 613 S.W.2d 240 (Tex.1981); *Sartor v. United Gas Public Service Co.*, 186 La. 555, 173 So. 103, 105 (1937); *Sartor v. United Carbon Co.*, 183 La. 287, 163 So. 103, 103 (1935).

contract, it received a higher initial price and an agreement for a substantially higher daily take of gas than could have been negotiated with other pipelines in the area. Lessee considered plaintiff's position untenable as no purchaser would buy large quantities of gas on a day-to-day or other short term basis. The *Foster* court rejected defendants' arguments stating:

> ". . . [t]he obligation of Atlantic to pay royalties is fixed and unambiguous. It made the gas sales contract with full knowledge of this obligation and did nothing to protect itself against increases in price. The fact that its purchaser would not agree to pay the market price prevailing at the time of deliveries does not destroy the lease obligation."[48]

Furthermore, the court concluded that

> ". . . the 1950 contract was an executory contract for the sale of gas with an executed sale of gas being effected when the gas came into possession of the pipeline. . . . The lease calls for royalty based on the market price prevailing for the field where produced when run. The fact that the ascertainment of future market price may be troublesome or that the royalty provisions are improvident and result in a financial loss to Atlantic is not a web of the Court's weaving."[49]

Shell attempts to distinguish *Foster* and *Vela* on the basis of the language contained in the respective royalty provisions. The district court in *Kingery v. Continental Oil Co.*, 434 F.Supp. 349, 353-54 (W.D.Tex.1977), *rev'd on other grounds*, 626 F.2d 1261 (5th Cir. 1980), concluded

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48. 329 F.2d at 489.

49. *Id.* at 489-90.

otherwise. The court in *Kingery* found that the decisions in *Vela* and *Foster* were predicated on an earlier Texas ruling, *Martin v. Amis, supra,* which held that a contract for the sale of gas is an executory contract with the sale being effected only upon delivery. The execution of the contract does not constitute a completed sale and does not confer any rights unto the parties while the gas remains in place.

The royalty provision in *Kingery* is similar to the Producers 88-D9803 considered in the instant case. It provides for gas royalty as follows:

> ". . . [where gas is] sold or used off the premises . . . the market value at the well of one-eighth of the gas so sold or used, provided that on gas sold at the well, royalty shall be one-eighth of the amount realized from such sale."

The court, relying on *Vela* and *Foster* as definitive of the market value issue, concluded that market value is to be determined as of the time of delivery, that a completed sale[50] of gas does not occur at the time of the execution of the initial sale contract, and finally, that the differences in the language in *Vela* and *Foster* was a "distinction without a difference."[51]

In *Sartor v. United Carbon Co.*, 183 La. 287, 163 So. 103 (1935), plaintiffs sought to recover alleged deficiencies

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50. Defendant relies upon *Phillips Petroleum Co. v. Wisconsin,* 347 U.S. 672, 74 S.Ct. 794, 98 L.Ed. 1035 (1964) and *United Gas Improvement Co. v. Continental Oil Co.,* 381 U.S 392, 85 S.Ct. 1517, 14 L.Ed.2d 466 (1965) for the proposition that a total, completed sale takes place upon signing the initial contract. However, the court in *Kingery* stated that these rulings were merely determinations that such contracts were to be regulated by the Natural Gas Act and not that such contracts constituted a complete sale upon execution. 434 F.Supp. at 354.

51. 434 F.Supp. at 353.

in royalty payments, and as early as 1935, the Louisiana Supreme Court, relying on *Wall v. United Gas Public Service Co.*, held that the language in the lease requiring that royalty be paid market price at the well was synonymous with market price at the field where produced. Two years later in *Sartor v. United Gas Public Service Co.*, 186 La. 555, 173 So. 103 (1937), the Louisiana court stated that ". . . [w]here there is no stipulation to the contrary, . . . 'market value' is understood to mean the current market price paid for gas in the well or field where produced."[52]

In the case of *J. M. Huber Corp. v. Denman*, 367 F.2d 104 (5th Cir. 1966), the meaning of "market value" was discussed by the Fifth Circuit. Royalty owners contended they were entitled to receive royalties based on current market value rather than a stated percentage of the price received by the lessee from its pipeline purchaser. The lessors refused to enter a lease agreement with the lessee until it procured a purchaser. The lessee contended that "market price" in the lease was not to be used in its traditional sense since the gas had a specified market, its contract; the market price of such committed gas was the amount received for such gas delivered to its specified market; and, the lessors are estopped from asserting the existence of another market because of their participation in committing this gas. The Court of Appeals disagreed with the lessors' contentions, holding that "market value" should be construed literally and not as synonymous with or identical to the proceeds received under the contract. The court determined that the lessors' condition precedent, the execution of the contract with a pipeline purchaser, signified their desire to be paid royalties on the current value of the gas being delivered.

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52. 173 So. at 105.

Indeed, in the companion case to *Huber, Weymouth v. Colorado Interstate Gas Co.*, 367 F.2d 84 (5th Cir. 1966), the Fifth Circuit defined "market value" in interstate sales of gas as "what a willing seller and willing buyer in a business which subjects them and the commodity to restriction and regulation, including a commitment for a long time period, would agree to take and pay. . . ."[53] The court then clarified its definition of market value stating that the question is "in a business in which gas is sold under long term commitments, what is the *current* price which it theoretically would bring?"[54] (emphasis supplied). According to the Kansas Supreme Court in *Lightcap v. Mobil Oil Corp.*, 221 Kan. 448, 562 P.2d 1, 5-6 (1977), the *Weymouth* and *Huber* cases stand for the proposition that market value is not synonymous with actual proceeds. Moreover, the Kansas court construed *Huber* to mean that a "market value lease *on its face* calls for payment at the theoretical free market value."[55] (emphasis supplied).

Shell supports its contention that the contract price governs royalty payments by relying upon the "'immediate sale' concept" advanced by the Mississippi Supreme Court in *Simpson v. United Gas Pipeline Co.*, 196 Miss. 356, 17 So.2d 200, 202 (1944). According to Defendant, the *Simpson* case conclusively established that the gas is "sold" upon execution of the gas sales contract. The lessors in *Simpson* sought royalty computed upon market value rather than amount realized. The lessee's contract with its purchaser required that a division order, executed by royalty, be provided. The court found that the division order, which incorporated the lease agreement, stated that the owners were to be paid in accordance with

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53. 367 F.2d at 90.

54. *Id.* at 91, n.26.

55. 562 P.2d at 6.

the contract, thus clearly establishing and fixing the basis on which royalty was to be paid as the contract price. In the court's words there was "an immediate sale of the gas". *Simpson* is clearly distinguishable in that the division order dictated the price on which royalty was to be computed.[56] The Mississippi Supreme Court, bound by the provisions of the division order, did not consider the market value issue.

[17] After careful consideration of the testimony elicited on this issue, the extensive briefs submitted by counsel[57] and the policy arguments advanced, this Court concludes that the term "market value", as found in the royalty provisions in this cause, means current market value rather than the contract price. The Court further concludes that the holdings in *Vela*, *Foster* and *Wall* apply to this case regardless of the disparities in the gas royalty provisions. The conclusions of this Court are founded upon the premise expressed in those cases that a contract

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56. *See Kingery v. Continental Oil Co.*, 434 F.Supp. 349, 356 (W.D.Tex.1977), *rev'd on other grounds*, 626 F.2d 1261 (5th Cir. 1980) (division orders executed in 1951 and 1952 may bar plaintiff's claims for additional royalties under those contracts) *But see, Craig v. Champlin Petroleum Co.*, 300 F.Supp. 119, 125 (W.D.Okl.1969), *aff'd*, 421 F.2d 236 (10th Cir. 1970) (lessors are not estopped from claiming higher royalties based on market price by division orders); *Butler v. Exxon Corp.*, 559 S.W.2d 410, 417 (Tex.Civ.App.1977) (same); *J. M. Huber Corp. v. Denman*, 367 F.2d 104, 110 (5th Cir. 1966) (division orders constitute a definite basis for payment so that payments made in accordance therewith are final and binding, although they may be withdrawn as to future payments); *Phillips Petroleum Co. v. Williams*, 158 F.2d 723, 727 (5th Cir. 1947) (same).

57. Defendant-Shell also relies on two Oklahoma cases, *Pierce v. Texas Pacific Oil Co. Inc.*, 547 F.2d 519 (10th Cir. 1976) and *Apache Gas Products Corp. v. Oklahoma Tax Commission*, 509 P.2d 109 (Okl.1973). We find these two cases clearly distinguishable in that both were resolved on the basis of the construction of a particular Oklahoma tax and communitization statute. Therefore., these cases have no bearing on the issue at hand.

for the sale of gas is executory in nature with an executed sale being effected only at the time gas is delivered to the purchaser. The Court finds further support for its conclusions in the Uniform Commercial Code, Miss.Code Ann. Sections 75-2-105 and 75-2-107 (Supp.1978). Section 75-2-105 provides as follows:

> "(1) 'Goods' means all things (including specially manufactured goods) *which are moveable at the time identification to the contract for sale*. . . . 'Goods' also includes the unborn young of animals and growing crops and other identified things attached to realty and described in the section on goods to be severed from realty (§ 75-2-107).
>
> "(2) Goods must be both *existing and identified before any interest in them can pass. Goods which are not both existing and identified are 'future' goods. A purported present sale of future goods or of any interest therein operates as a contract to sell.*" (emphasis added).

Section 75-2-107 provides as follows:

> "(1) A contract for the sale of minerals or the like (including oil and gas) or a structure or its materials to be recovered from realty is a contract for the sale of goods within this chapter if they *are to be severed by the seller but until severance a purported present sale thereof which is not effective as a transfer of an interest in land is effective only as a contract to sell.*" (emphasis added).

The Court concludes that Sections 75-2-105—107 support the reasoning of the decisions in *Vela*, *Foster*, and *Wall*, and that a complete sale did not occur upon the execution of the initial contract. The subject gas was sold when it reached the points of sale designated in the sales con-

tracts; therefore, "market value" under the subject royalty provisions is construed as "current market value" unless otherwise specified.

V

Comparables

Having determined that market value is to be construed as current market value, it is now incumbent upon the Court to determine how such value is to be computed in the instant case. Our discussion begins with *Texas Oil and Gas Corp. v. Vela*, 429 S.W.2d 866 (Tex.1968).

As previously stated, the Texas Supreme Court held in *Vela* that when the gas royalty clause of an oil, gas and mineral lease is based upon a "market value" standard, royalty is entitled to payment based upon market price prevailing at the time of physical delivery and not upon the market price as determined at the time of commitment. In regard to determining market value, the court concluded that such is to be determined by sales of gas comparable in time, quality, and availability to marketing outlets.[58] Moreover, the *Vela* court cautioned that "the mathematical average of all prices paid in the field is not a final answer to the difficult problem of determining market price at any particular time."[59]

After a review of the evidence, the court concluded that the testimony of the royalty interest owners' expert witness, a petroleum and natural gas consulting engineer,

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58. The "comparability" test announced in *Vela* was borrowed from *Phillips Petroleum Co. v. Bynum*, 155 F.2d 196, 199 (5th Cir.), *cert. denied*, 329 U.S. 714, 67 S.Ct. 44, 91 L.Ed. 620 (1946), wherein the Fifth Circuit stated that "the test is what do such producers pay for gas similar in quantity, quality, and availability to market."

59. 429 S.W.2d at 873.

provided the necessary scintilla of evidence to support the trial court's decision to award royalty a recovery based upon such testimony. The expert related his familiarity with the field in question and his study of production and gas sales from the field. The principal sources of his information were records of sales in the office of the Comptroller of Public Accounts and sales contracts made by various producers in the field. The expert then ascertained the volumes of gas sold from each well in the field and the amounts received for same during the period in question. By mathematical calculation, the average price received for all gas sold during that period was determined. The expert recognized that market value might be affected by the type, the quality, the pressure, the reserves[60] and the deliverability. Where applicable, compression charges were deducted.

The expert made a market value determination which involved calculation of "average price" received for gas sold from the field during that period by dividing the value received for the gas sold by the volume thereof. Although the *Vela* court accepted the expert's testimony as sufficient to support the judgment, corroboration by actual gas sales from wells in the field with comparable net prices was significant in the court's decision. Despite the opportunity to develop definitive guidelines regarding a method to compute market value, the court retreated from an in-depth analysis of the issue.

The *Vela* court's solution for calculating market value was criticized and rejected in *Butler v. Exxon Corporation*, 559 S.W.2d 410, 416 (Tex.Civ.App.1977). The court in *Butler* disapproved of *Vela's* volume-weighted average formula, and instead accepted market value figures calculated

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60. The expert noted that reserves are not a significant factor when there are existing pipelines in the field.

by plaintiff's expert. Plaintiff's expert, Max Powell, began his testimony with a tabulation of gas sales in a seven-county area in South Texas. Under his approach, the top three sales in the county for each quarter were averaged to determine market value during such period. He stated that all sales used in the computations were comparable in quantity, quality, and availability of gas and that his determination was based on new gas coming into the market under current market conditions. Defendant-lessee failed to offer testimony in rebuttal. The court, again declining to resolve the issue, chose to follow the unrefuted testimony of plaintiff's expert. This case is illustrative of the *ad hoc* basis upon which the resolution of this most important and illusive issue has been made.

Hoping to glean a ray of hope, this Court turns to *Exxon Corporation v. Middleton*, 571 S.W.2d 349 (Tex.Civ. App.1978), *rev'd*, 613 S.W.2d 240 (Tex.1981), the case chosen by the Texas Supreme Court to serve as vehicle for its attempt to clarify application of the *Vela* decision.[61] In *Middleton*, the court discussed and clarified the method for determining market value of gas committed under long-term contracts utilizing a two-tiered approach which focused on when gas is sold and on how market value is determined. The comparability test announced in *Vela* was reiterated and expounded upon by the court. The following principles of broad applicability emerged.

(1) Market value should be determined as though the gas is free and available for sale;

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61. The Texas Supreme Court considered the issue of whether the sales of gas occurred "at the well" or "off the premises" to be more important; thus overruling the decision in *Butler v. Exxon Corp.*, 559 S.W.2d 410 (Tex.Civ.App.1977), regarding this point.

(2) Market value may be calculated by using sales of gas comparable in time, quality, quantity, and availability to marketing outlets;

(3) Sales comparable in time are those made under contracts executed contemporaneously with the sale of the subject gas;

(4) Sales comparable in quality are those of gas having similar physical properties and legal characteristics;

(5) Sales comparable in quantity are those of gas sold in similar volumes;

(6) Sales of gas comparable with respect to availability of marketing outlets are those which could have been sold to the same type market (e.g., intrastate or interstate);

(7) Comparable sales should be drawn from the relevant market area which may be, but is not required to be, the field from which the subject gas is produced.[62]

According to the *Middleton* court, comparability in time requires that the sales occur "under contracts executed contemporaneously with the sale of the gas in question",[63] or, in other words, the contract execution date rather than the date of delivery determines comparability. Additionally, to be comparable, contracts must have similar obligations between the parties.

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62. *See*, Holliman, *Exxon Corp. v. Middleton: Some Answers But Additional Confusion in the Volatile Area of Market Value Gas Royalty Litigation*, 13 St. Mary's L.J. 1, 43 (1981).

63. 613 S.W.2d at 246. *Compare Kingery v. Continental Oil Co.*, 434 F.Supp. 349, 355 (W.D.Tex.1977), *rev'd*, 626 F.2d 1261 (1980) (comparability as to time depended on the date of delivery, regardless of the contract date) *with Butler v. Exxon Corp.* 559 S.W.2d 410, 413 (Tex.Civ.App.1977) (court accepted expert's opinion of market value which admittedly was based upon new gas coming into the market under current market conditions).

Comparability in quality requires not only similarity in physical properties, i.e., sweet, sour or casinghead gas,[64] but also in legal characteristics, such as whether the gas is sold in the intrastate or interstate market.[65]

In addition to considering sales similar in time and quality, *Middleton* required that comparable sales be limited to those involving similar quantities of gas.[66]

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64. The expert testifying in *Vela*, 429 S.W.2d 866, 872 (Tex. 1968), adjusted the computed market price for differences in well pressure for some of the sales included in the computations.

65. *See Kingery v. Continental Oil Co.*, 626 F.2d 1261, 1264 (5th Cir. 1966) (comparable sales are those derived solely from the interstate or intrastate markets); *Weymouth v. Colorado Interstate Gas Co.*, 367 F.2d 84, 88-93 (5th Cir. 1966) (interstate sales); *Phillips Petroleum Co. v. Bynum*, 155 F.2d 196, 199 (5th Cir.), *cert. denied*, 329 U.S. 714, 67 S.Ct. 44, 91 L.Ed. 620 (1946) (testimony regarding interstate sales is incompetent); *Domatti v. Exxon Corp.* 494 F.Supp. 306, 309 (W.D.La.1980) (intrastate sales are not comparable for determining the market value of regulated gas); *Brent v. Natural Gas Pipeline Co.*, 457 F.Supp. 155, 162 (N.D.Tex.1978), *aff'd*, 626 F.2d 1261 (5th Cir. 1980) (only interstate sales are admissible to determine market value of regulated gas); *Hemus & Co. v. Hawkins*, 453 F.Supp. 861, 864-65 (S.D.Tex.1978) (same); *First National Bank in Weatherford v. Exxon Corp.*, 597 S.W.2d 783, 785 (Tex.Civ.App.1981) (same); *Exxon Corp. v. Jefferson Land Co.*, 573 S.W.2d 829, 831 (Tex.Civ.App.1978); *Butler v. Exxon Corp.*, 559 S.W.2d 410 (Tex.Civ.App.1977); *Amoco Prod. Co. v. First Baptist Church of Pyote*, 579 S.W.2d 280, 288-89 (Tex.Civ.App.1979); *Sartor v. United Gas Public Service Co.*, 186 La. 555, 559, 173 So. 103, 105 (1937); *Wall v. United Gas Public Service Co.*, 179 La. 908, 918, 152 So. 561, 565 (1934). *But see, Lightcap v. Mobil Oil Co.*, 221 Kan. 448, 562 P.2d 1, 8, *cert. denied*, 434 U.S. 876, 98 S.Ct. 228, 54 L.Ed.2d 156 (1977) (intrastate and interstate sales are comparable).

66. Note that the *Vela* decision omitted the requirement that comparable sales be of similar volumes. 429 S.W.2d 866, 872 (Tex.1968). Plaintiffs' expert testified that reserves were unimportant in valuation of market value when pipelines have already been laid in the [illegible] *Id. Cf. Phillips Petroleum Co. v. Bynum*, 155 F.2d 196, 199 (5th Cir.), *cert. denied*, 329 U.S. 714, 67 S.Ct. 44, 91 L.Ed. 620 (1946) (the court, construing Texas law, stated that the test for market value is what do producers pay for gas similar in quantity, quality, and availability to market).

Lastly, to be comparable, sales must be derived from those whose availability to marketing outlets is similar to the gas in question. Moreover, comparable sales should be drawn from the relevant market area. Declining to follow *Vela's* conclusion that the relevant market area extended only to the field[67] from which the gas was produced, the *Middleton* court found that the size of the relevant market area depended upon the facts in each case.

The plaintiff-royalty owner's expert in *Middleton* reviewed over 30,000 Purchasers' Monthly Gas Tax Reports to formulate his opinion of market value. These reports, filed monthly with the Texas State Comptroller of Public Accounts, contain the name of the purchaser and seller, the month and year of each sale, the lease and county of production, quality, volume, price and whether the gas was produced from an oil well or a gas well. To arrive at his opinion of market value, the expert computed the arithmetical average of the three highest prices paid for the first month of each quarter for any quantity of gas anywhere in the relevant market area designated as Texas Railroad Commission Districts 2, 3 and 4. By expert testimony, Exxon sought to convince the court that its "field price" was market value. Field price is calculated by dividing the total price paid for gas currently being delivered to all major purchasers in one month for each quarter by the total volume of gas delivered. The "field" utilized by Exxon's expert was Texas Railroad Commission District 3 plus seven adjoining counties.

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67. *Phillips Petroleum Co. v. Bynum*, 155 F.2d 196, 198 (5th Cir. 1946) (the court stated that the question was not what happened in the county where the gas was produced, but whether or not there have been recent, substantial and comparable sales of like gas from wells in the area whose availability for marketing is reasonably or substantially similar to that of the gas involved).

The trial court adopted plaintiff's expert's determination of market value. On appeal, the Court of Civil Appeals disapproved of both experts' opinions: plaintiff's, because it failed to satisfy *Vela;* and Exxon's, because its price was computed in part on interstate sales. The Supreme Court of Texas held that testimony by plaintiff's expert was sufficient to support the trial court's determination of market value and affirmed usage of Texas Railroad Commission Districts 2, 3 and 4 as the relevant market area based on testimony that price redetermination clauses of many gas purchase contracts utilized that as the relevant market area for gas produced along the Gulf Coast. Sales on which the expert relied were found to be comparable in quality as most of the gas was "sweet" and all moved in the intrastate market. Moreover, the court noted that the expert adjusted his figures to compensate for variances in Btu content[68] and that the sales were comparable regardless of the volume. The court concluded that the expert also satisfied requirements of comparability in time and availability to marketing outlets. The Supreme Court rejected Exxon's computations because its sales were not comparable in quality (Exxon's "field price" included interstate, as well as intrastate sales) and because Exxon made a distinction in the method of computing field price depending on the gas' vintage.

The *Middleton* court elaborated somewhat on the comparability test enunciated in *Vela* and reiterated *Vela's* conclusion that "a mathematical average of all prices paid in the field is 'not a final answer to the difficult problem of determining market value at any particular time.' " How-

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68. "Btu" is the abbreviation for British thermal unit, the amount of heat needed to raise the temperature of one pound of water one degree Fahrenheit. Williams and Meyers, *Oil and Gas Law*, "Manual of Terms".

ever, the *Middleton* court failed to adopt the formula on which *Vela* relied in determining market value. The *Vela* court had approved the expert's calculation which computed market value as the average price received for *all* gas sold in the field. The *Middleton* court accepted the expert's determination of market value derived from the arithmetical average of the *three highest prices* of gas sales in the relevant market area. This approach had been utilized by the expert in *Butler v. Exxon Corporation*, 559 S.W.2d at 413.

In *Exxon Corporation v. Jefferson Land Company, Inc.*, 573 S.W.2d 829 (Tex.Civ.App.1978), Exxon proposed to compute market value by obtaining records from the Comptroller's office which reflected amounts paid for each quarter for all natural gas by all producers in the Texas Railroad Commission District No. 3 and seven other East Texas counties. Gross receipts were then divided by total production which resulted in the "weighted average market price". The court in *Jefferson* approved of such method.[69]

Any determination of market value initially requires designation of a relevant market area from which comparable sales may be drawn. The Texas courts have recognized that the market area will vary according to the facts in each case.[70] Once relevant market area is established,

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69. The court noted that this weighted average market price was appropriate only for gas produced after January 1, 1973. 573 S.W.2d at 831. Accordingly, the weighted average market price was that price at which all gas produced in the area by all producers was sold under contracts entered into after January 1, 1973. *Id.* The court stated that much of the gas sold was under contracts made before January 1, 1972. *Id.* However, no mention was made of the treatment these sales received in determining market value.

70. *See Exxon Corp. v. Middleton*, 613 S.W.2d 240, 247 (Tex.1981) (size of the market area depends upon the facts in the case; in this instance, Texas Railroad Commission Districts

(Continued on following page)

comparable sales within that area form the basis for calculating market value. Because of the sophistication and complexity of the industry, courts have come to rely on industry experts to formulate methods of computing market value. Generally, these experts are allowed reasonable flexibility and discretion in explaining the rationale and facts underlying their opinions.[71] Their opinions may be based upon sales that are fairly comparable and objections go to weight and not admissibility.[72] Indeed, in most cases, "some evidence" supportive of the trial court's determination of market value has been deemed sufficient to sustain the court's finding.[73]

[18] However, this Court hesitates to blindly follow the opinions given by industry experts. In the case *sub judice*, it is our conclusion that the data relied upon Plain-

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Footnote continued—

Nos. 2, 3, 4 were utilized which included most of the Texas Gulf Coast); *Texas Oil & Gas Corp. v. Vela*, 429 S.W.2d 866, 872 (Tex.1968) (the "field" comprised the relevant market area); *Amoco Prod. Co. v. First Baptist Church of Pyote*, 579 S.W.2d 280, 287 (Tex.Civ.App.1979) (field); *Exxon Corp. v. Jefferson Land Co.*, 573 S.W.2d 829, 831 (Tex.Civ.App.1978) (Railroad Commission District No. 3 plus seven other east Texas counties); *Butler v. Exxon Corp.* 559 S.W.2d 410, 413, 417 n.2 (Tex.Civ. App.1977) (expert began with a seven-county area and ultimately concentrated on a two-county area). *See also, Phillips Petroleum Co. v. Bynum*, 155 F.2d 196, 198 (5th Cir.), *cert. denied*, 329 U.S. 714, 67 S.Ct. 44, 91 L.Ed. 620 (1946) ("wells in the area"); *Brent v. Natural Gas Pipeline Co. of America*, 457 F.Supp. 155, 160 (N.D.Tex.1978), *aff'd, sub nom. Kingery v. Continental Oil Co.*, 626 F.2d 1261 (5th Cir. 1980) (market area defined as "the geographical area in which the wells producing such gas were located"); *Kingery v. Continental Oil Co.*, 434 F.Supp. 349, 351 (W.D.Tex.1977), *rev'd*, 626 F.2d 1261 (5th Cir. 1980) (relevant market area described as the "immediate vicinity").

71. *Exxon Corp. v. Middleton*, 613 S.W.2d 240, 249 (Tex. 1981) quoting *Weymouth v. Colorado Interstate Gas Co.*, 367 F.2d 84, 91 (5th Cir. 1966).

72. 613 S.W.2d at 249.

73. *Id.* See also, *Texas Oil & Gas Corp. v. Vela*, 429 S.W.2d 866, 869, 874 (Tex.1968).

tiffs' expert, Mr. Max Powell, in formulating his opinion regarding market value, fails to satisfy the comparability tests enunciated in *Vela* and *Middleton* and that his method of computation fails to accommodate necessary factors in determining the market value of the subject gas. This Court scrutinized the testimony presented by Powell and struggled without success to find demonstrative comparability in sales on which Powell relied and to understand the theoretical basis for his computation. Such is not surprising in light of the treatment heretofore accorded this issue.[74]

[19] After considerable analysis, this Court makes the following conclusions with regard to determining comparability of sales in the oil and gas industry:

First, sales must be comparable in time. This standard requires that market value be derived from contracts executed contemporaneously with the sale of the subject gas. This Court previously determined that contracts for the sale of gas are executory contracts with completion occurring upon delivery. This conclusion, of necessity, requires an examination of all contracts for the sale of gas, *otherwise comparable,* executed since the date of the first sales of the subject gas.

Gas is comparable in quality when its properties are legally and physically similar. Legal comparability requires that the gas sales compared must occur in the same market, interstate or intrastate. Physical comparability limits analysis of comparable sales to those sales having similar characteristics. One must consider and take into

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74. In good faith we cannot follow *Butler v. Exxon Corp.*, 559 S.W.2d 410 (Tex.Civ.App.1977), wherein the court accepted the testimony of Max Powell due to the failure of defendant to refute his testimony.

account in finding comparability, whether the compared gas is sweet or sour, its BTU content and its pressure.

Comparability in quantity indicates that the sales of gas compared must be of similar volumes.

Lastly, to be comparable, sales must be derived from those whose availability to marketing outlets is similar to the gas in question. Availability to marketing outlets takes into consideration potential customers, deliverability, and reserves.

As a matter of law, courts have held that comparability in sales requires only that the sales be reasonably similar. The Court anticipates that it will be difficult to find sales that are truly comparable. Despite the apparent flexibility which "reasonable similarity" imparts, it is incumbent upon the parties, in the first instance, to present relevant evidence of comparable sales and upon the court in the second instance, to scrutinize and weigh such evidence to ensure its probative value.

[20] Defendants have indefatigably maintained that sales of sweet gas cannot be compared to sales of the subject gas which, in its raw state, is sour. The Court can readily perceive that the two are incomparable and that their sales prices would vary significantly. Sour gas is less valuable because of expenses necessary to render it merchantable. However, the subject gas is comparable to sweet gas in that it is processed prior to marketing.[75]

From the testimony at trial, it is apparent that oil and gas resources in Mississippi are relatively undeveloped

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75. After deductions for processing, etc., royalty for the subject gas is paid on the "wellhead value", or its sour gas value. Such payment is of no consequence in comparison of sales prices of sweet and sour gas.

and that production from the subject fields was an unprecedented discovery in its volume, deliverability and reserves. While the Court believes that such would render sales of the subject gas comparable to any sale of gas otherwise comparable, these factors limit comparability in view of the requirement that sales be similar in their *quantity* and *availability to market*. The unprecedented volume, deliverability and reserves of production in the Thomasville, Piney Woods and Southwest Piney Woods Fields distinguishes the subject gas from other discoveries in Mississippi. Ideally, sales relied upon should be comparable in these respects. In states having more extensive oil and gas production, the quest for comparability would not be complicated, as here, by their absence. Appreciating this difficulty, the Court has formulated a method for computing market value which we believe accounts for these novel circumstances. Additionally, we believe this method of computation addresses the escalating price of gas while acknowledging the reality of the oil and gas industry that gas is generally committed under long-term contracts even though sold upon delivery.

[21] As discussed above, courts addressing this issue have used various approaches in computing market value. In *Vela*, the court mathematically computed an average of *all* sales in the field during the relevant time by dividing the value received by the volume sold. In *Jefferson*, the court computed market value by dividing the *total receipts* reported for one month in each quarter for gas delivered in the market area by the *total volume* of gas delivered. In *Butler* and in *Middleton*, the courts accepted a mathematical average of the *highest three prices* in the relevant market area computed for the first month of each quarter during the relevant period. By far the easier solution for this Court would be the adoption of one of these

methods. The Court, however, believes there is a more equitable approach available which will acknowledge more fully the requirements of comparability. Once the relevant market area is defined and comparable sales are identified, the Court concludes that computation of market value should be made by the division of net sales receipts derived from sales of comparable gas (after necessary adjustments for variances in Btu content and compression charges) by the total volume sold.[76]

The Court has not undertaken an assignment of a dollar and cent valuation to the subject gas because of the lack of relevant evidence addressing comparability. We recognize the necessity for further proof on this matter and hereby instruct the attorneys to contact the Court for direction.

IV

Attorney's Fees and Prejudgment Interest

Plaintiffs contend they are entitled to recover their attorneys' fees and costs, including expert expenses, due to Defendant's alleged bad faith in handling Plaintiffs' royalty payments. Defendant submits Plaintiffs' claim for such relief are based upon a frivolous allegation of bad faith. Both parties rely upon *Alyeska Pipeline Service Co. v. The Wilderness Society*, 421 U.S. 240, 95 S.Ct. 1612, 44 L.Ed.2d 141 (1977), for support.

According to *Alyeska*, the "American Rule" dictates that: ". . . the prevailing litigant is ordinarily not entitled to collect a reasonable attorneys' fee from the loser, . . . absent statute or enforceable contract, . . . willful

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76. The Court does not decide at this point whether market value computations will be made monthly or quarterly.

disobedience of a court order, . . . or when the losing party has acted in bad faith, vexatiously, wantonly, or for oppressive reasons. . . .'"[77]

[22, 23] Before this punitive device is triggered, it is essential that the successful litigant substantiate the existence of "bad faith" by the unsuccessful litigant. The record in the case *sub judice* is totally devoid of any basis for awarding attorneys' fees and costs against Shell under the "bad faith" exception to the American Rule. Therefore, Plaintiffs are not entitled to this relief.

Plaintiffs further contend they are entitled to recover six percent (6%) simple interest on the amounts of royalty they allege were wrongfully withheld by Shell from the date that royalty should have been paid until the present. Defendant maintains that prejudgment interest is appropriate in Mississippi only where the plaintiff's claim was liquidated or where the defendant's denial of the claim was frivolous or in bad faith.

[24, 25] This Court concludes that pursuant to Mississippi law, prejudgment interest is inappropriate in this case. According to *Home Insurance Co. v. Olmstead*, 355 So.2d 310, 313-14 (Miss.1978), prejudgment interest may be allowed only in cases where the amount allegedly due was liquidated when the claim is originally made or where the denial of a claim was frivolous or in bad faith. *See also, Mitchell v. Aetna Casualty & Surety Co.*, 579 F.2d

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77. 421 U.S. at 247-259, 95 S.Ct. at 1616-1622. *F. D. Rich Co., Inc. v. United States ex rel. Industrial Lumber Co. Inc.*, 417 U.S. 116, 129, 94 S.Ct. 2157, 2165, 40 L.Ed.2d 703 (1974); *Vaughn v. Atkinson*, 369 U.S. 527, 82 S.Ct. 997, 8 L.Ed.2d 88 (1962). *See also, Hall v. Cole*, 412 U.S. 1, 93 S.Ct. 1943, 36 L.Ed.2d 702 (1973); *Newman v. Piggie Park Enterprises, Inc.*, 390 U.S. 400, 88 S.Ct. 964, 19 L.Ed.2d 1263 (1968); *Knights of Ku Klux Klan, Realm of Louisiana v. East Baton Rouge Parish School Board*, 643 F.2d 1034, 1036-37, n.1 (5th Cir. 1981); *Blue v. Bureau of Prisons*, 570 F.2d 529, 531-32 (5th Cir. 1978).

342, 352 (5th Cir. 1978); *Dunn v. Koehring Co.*, 546 F.2d 1193, 1201 (5th Cir.), *reh. denied in part, granted in part*, 551 F.2d 73 (5th Cir. 1977); *Charles Stores, Inc. v. Aetna Insurance Co.*, 327 F.Supp. 525, 527 (N.D.Miss.1971), *aff'd*, 490 F.2d 64 (5th Cir. 1974); *Commercial Union Insurance Co. v. Byrne*, 248 So.2d 777, 783 (Miss.1971). Since neither situation exists in the present case, prejudgment interest will be denied.

An order in accordance with this opinion shall be submitted by the parties as provided by the Local Rules.

APPENDIX B

The PINEY WOODS COUNTRY LIFE SCHOOL, Ridgway Management, Inc., D'Lo Royalties, Inc., Thomas L. Spengler, Albert L. Fairley, Jr. and James V. Fairley, Executors of the Estate of Alethe V. Fairley, Individually, and all others similarly situated, Plaintiffs-Appellants,

v.

SHELL OIL COMPANY,
Defendant-Appellee.

No. 82-4287.

United States Court of Appeals,
Fifth Circuit.

March 8, 1984.

Royalty owners brought class action against lessee under gas leases claiming that lessee had improperly charged royalty owners for processing costs, that lessee had breached duty to market, and that lessee's method of calculating royalty payments was violative of certain of lease agreements. The United States District Court for the Southern District of Mississippi, at Jackson, Dan M. Russell, Jr., J., 539 F.Supp. 957, found for the lessee, except on one relatively minor issue, and certified appeal. The Court of Appeals, Wisdom, Circuit Judge, held that: (1) term "at the well" referred to gas in its natural state, before processing or transportation, and thus gas sold by lessee under certain contracts was therefore not "sold at the well" within meaning of the leases; (2) term "market value" in leases meant market value of gas when gas was

produced and delivered, and royalty was to be based on value or price of the gas before processing or transportation; but (3) processing and transportation costs could be deducted from values or prices established for processed and transported gas and, although lessors were entitled to royalty on plant fuel, lessee could include these royalties as processing costs.

Judgment affirmed in part, reversed in part and remanded for determination of damages in accordance with opinion.

1. Federal Courts (Key) 660

That one fact, i.e., market value of gas, was relevant to several claims, did not make claims not decided inseparable from those certified for appeal, and where only thing left for plaintiffs to do in District Court was to present lengthy evidence on market value of small amount of gas which defendant used in off-lease operations and where plaintiffs' potential recovery would not justify expense of such proof, district court acted wisely and in interests of sound judicial administration in certifying case. Fed.Rules Civ.Proc.Rule 54(b), 28 U.S.C.A.

2. Mines and Minerals (Key) 79.3

Purpose of distinction, in royalty clauses, between gas sold at well and gas sold off the lease is to distinguish between gas sold in form in which it emerges from the well, and gas to which value is added by transportation away from the well or by processing after the gas is produced, and thus "at the well" describes not only location but quality as well, and market value at well means market value before processing and transportation, and gas is sold at the well if price paid is consideration for gas as produced but not for processing and transportation.

Natural Gas Act, §§ 1-607, as amended, 15 U.S.C.A. §§ 717-717z; Energy Policy and Conservation Act, § 529, 42 U.S.C.A. § 6399.

See publication Words and Phrases for other judicial constructions and definitions.

3. Mines and Minerals (Key) 56

Uniform Commercial Code applies to sales of natural gas and therefore governed sale contract between lessee of mineral rights and buyers of gas. Miss.Code 1972, §§ 75-2-105(4), 75-2-107(1), 75-2-401(1), 75-2-501(1); U.C.C. § 1-101 et seq.

4. Mines and Minerals (Key) 73(1)

Mississippi law does not allow lessors' rights under oil and gas lease to turn on "happenstance" of point of delivery, especially when point of delivery is in lessee's control.

5. Sales (Key) 216

Mississippi law looks beyond formal passage of title when interests of persons not party to contract are at stake, and an agreement between buyer and seller on place for title to pass need not be conclusive for purposes of laws extrinsic to the contract. Miss.Code 1972, §§ 75-2-105(4), 75-2-107(1), 75-2-401(1), 75-2-501(1).

6. Mines and Minerals (Key) 79.3

Under Mississippi law, reference in oil and gas lease to "sold at the well" was not controlled by point at which title passed in sale contract, and, in case at bar, gas was not "sold at the well" within meaning of two different royalty provisions contained in lease forms, and, accordingly, royalties under such leases were to be computed on basis of "market value at the well" rather than actual proceeds.

7. Mines and Minerals (Key) 56

Gas sale contract is executory, and sale is executed only upon production and delivery. Miss.Code 1972, §§ 75-2-105, 75-2-107(1).

8. Mines and Minerals (Key) 56

Under Mississippi statute, gas underground is future goods, and no particular gas is sold until it is identified, i.e., brought to surface, the sale contracts being not transfers of interest in land but only contracts to sell, becoming effective as sales when gas is severed from the land. Miss.Code 1972, §§ 75-2-105, 75-2-107(1).

9. Mines and Minerals (Key) 73.1(2)

Under oil and gas leases, lessee had defeasible interest in gas underground, and the most it could sell was that same defeasible interest: in effect, right to possession of gas if it was produced before lease terminated. Miss.Code 1972, §§ 75-2-105, 75-2-106, 75-2-107(1).

10. Mines and Minerals (Key) 79.3

Gas lease may provide for royalties based on proceeds less processing, but where basis of royalty is "market value" at the well at time of production and delivery, applied to royalties not only on gas sold but also to gas used, market value may exceed actual proceeds.

11. Mines and Minerals (Key) 73(2)

Mineral leases are construed against lessee and in favor of the lessor.

12. Mines and Minerals (Key) 79.3

Market value clause in oil and gas lease serves in part to protect lessor from bad bargains by lessee.

13. Customs and Usages (Key) 3

Court would not find a "custom" binding on oil and gas lessors from alleged practice within control and understanding only of lessees.

14. Evidence (Key) 142(1)

Market value of gas at well was question of fact, and it was up to fact finder to determine the probative strength of relevant evidence, and where district court found that gas sales used by expert witness were made under conditions different enough to weaken their persuasiveness, court was within its discretion to seek evidence of sales it considered more nearly "comparable."

15. Mines and Minerals (Key) 79.3

Contract, while not conclusive evidence of market value of gas at well, was plainly relevant to the issue.

16. Mines and Minerals (Key) 79.3

In determining market value of gas at well, point is to determine price which reasonable buyer would have paid for gas at well when produced, and comparable sales of gas at other wells may be used to do this, but another method is to use sales of processed gas and deduct processing costs, and another relevant, but less desirable, measure of market price is actual sale price of gas less costs.

17. Evidence (Key) 142(1)

When court is fact finder, court as well as counsel may question expert opinions in arriving at market value of gas at well, but court should not dismiss fairly comparable sales out of hand because of certain incomparable qualities.

18. Mines and Minerals (Key) 79.7

Plaintiff lessors had burden of proof of market value of gas at well, and had burden to produce sufficient relevant evidence to support their contentions, but in doing so were not to be faced with impossible task of establishing market value with absolute certainty or perfection.

19. Mines and Minerals (Key) 79.3

Where oil and gas leases specified that royalty for gas was to be computed "at the well," subsequent costs of processing and transportation could be deducted by lessee, lessors being entitled to royalty based on value or price of unprocessed, untransported gas, but processing costs may not be deducted from royalties for gas "sold at the well," because price of such gas is based on its value before processing.

20. Mines and Minerals (Key) 79.3

Where apparently there were no comparable sales of sour gas at other wells in the area, market value of products resulting from processing was to be determined by examining sales of sweet gas and sulfur, and processing costs could then be deducted as indirect means of determining what buyer would have paid for the sour gas at the wellhead.

21. Mines and Minerals (Key) 79.3

Where, under provision of oil and gas lease, amount realized by lessee, computed at the mouth of the well, was to be basis of royalty for all gas sold, and not merely that sold at the well, as in other leases, processing expenses were to be deducted from amount realized from sales of sweet gas and sulfur to arrive at royalty basis.

22. Mines and Minerals (Key) 79.3

Lessee was entitled to make deductions for processing costs of gas, as well as to deduct costs of sulfur production.

23. Mines and Minerals (Key) 79.3

Costs of processing gas, deductible by oil and gas lessee under lease provisions, must be reasonable, and whether such requirement was met was issue to be left open for further consideration by the district court.

24. Mines and Minerals (Key) 79.3

Where oil and gas leases plainly called for market value royalty on gas used off-lease, royalty was to be determined on such basis, and where plant fuel was gas used off the lease, lessors were entitled to market value royalty on such gas, though lessee could treat royalty payments as processing costs to be divided, as any other processing costs, among various working and royalty interests.

25. Federal Civil Procedure (Key) 2737.5
Interest (Key) 39(2)

In suit by royalty owners against oil and gas lessee, wherein plaintiffs made no showing that lessee acted in bad faith either before or during litigation, nor was there shown any basis for holding lessee guilty of conversion, but, rather, lessee simply failed to pay royalties according to proper measure, thereby breaching contract, district court properly denied plaintiffs' request for attorney fees and costs and their request for prejudgment interest, on ground of bad faith and conversion, but affirmance on issue was without prejudice to right of attorneys representing plaintiff class to seek fees for their efforts on behalf of class at conclusion of litigation.

Heidelberg, Woodliff & Franks, Kenneth I. Franks, George F. Woodliff, III, Watkins, Ludlam & Stennis, Ernest G. Taylor, Jr., Larry Keith Parsons, Barnett, Alagia & Pyle, L. Arnold Pyle, Jackson, Miss., for plaintiffs-appellants.

Watkins & Eager, William F. Goodman, Jr., Paul H. Stephenson, III, Jackson, Miss., for defendant-appellee.

Appeal from the United States District Court for the Southern District of Mississippi.

Before BROWN, WISDOM and JOHNSON, Circuit Judges.

WISDOM, Circuit Judge:

This case concerns the interpretation of royalty clauses in certain Mississippi oil and gas leases. The plaintiffs are the owners of mineral rights in the Thomasville, Piney Woods, and Southwest Piney Woods fields in Rankin County, Mississippi. They leased their rights to defendant Shell Oil Company through various conveyances beginning in the mid-1960s. The cause of this controversy, as in many similar suits across the country, was the unforeseen and unprecedented rise in natural gas prices brought on principally by the actions of the Organization of Petroleum Exporting Countries (OPEC) in the early 1970s. Unfortunately for both the plaintiff lessors and lessee Shell, Shell had already committed the gas for sale under long-term contracts at pre-OPEC prices. Unsurprisingly, the lessors brought this class action to recover royalties that they allege Shell owes and has not paid. The district court found for Shell, except on one relatively minor issue, and certified this appeal so that the questions of liability could be decided before the determination of damages. We affirm in part, reverse in part, and remand.

I. *Facts*

The facts of this case are recounted in detail in the district court's opinion. *Piney Woods Country Life School v. Shell Oil Co.*, 1982, S.D.Miss., 539 F.Supp. 957. For our purposes it is enough to say that Shell began leasing activities in Rankin County in the 1960s. Shell used seven different lease forms, with three different royalty provisions.[1] The "Commercial" royalty provision provides for royalty

> ". . . on gas, including casinghead gas or other gaseous substance[s], produced from said land and sold or used, the market value at the well of one-eighth (⅛) of the gas so sold or used, provided that on gas sold at the well the royalty shall be one-eighth (⅛) of the amount realized from such sale[s]. . . ."

The "Producers 88-D9803" provision calls for royalty

> ". . . on gas, including casinghead gas or other gaseous substance, produced from said land and sold or used off the premises or in the manufacture of gasoline or other product therefrom, the market value at the well of one-eighth of the gas sold or used, provided that on gas sold at the wells royalty shall be one-eighth of the amount realized from such sale. . . ."

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1. We adopt the names that the district court used to refer to the various royalty clauses. The "Commercial" provision is found in the "Paid-up Mississippi Rev. 7/17/45" and "Commercial—Form CC-78" lease forms; the "Producers 88-D9803" provision is found in the "Producers 88-D9803 (Revised 10/1/48) with Pooling Provision" and "(Mississippi) Form 0-280 Rev. 3 (8-61) 5M-Producers 88 Rev." lease forms; the "Producers 88 (9/70)" provision is found in the "Producers 88 (9/70)—Paid up with Pooling Provision Mississippi-Alabama-Florida", "Producers 88 (9/70) with Pooling Provision-Mississippi-Alabama-Florida", and "Producers 88 Revised-Alabama-Mississippi (11/56)" lease forms. Brackets in the text indicate variations between the lease forms.

And the "Producers 88 (9/70)" provision orders the lessee

> ". . . to pay lessor on gas and casinghead gas produced from said land (1) sold by lessee, one-eighth of the amount realized by lessee, computed at the mouth of the well or (2) when used by lessee off said land or in the manufacture of gasoline or other products, the market value at the mouth of the well, of one-eighth of such gas and casinghead gas. . . ."

The Commercial and Producers 88-D9803 leases provide for royalty based on "market value" except when the gas is "sold at the well[s]"; the Producers 88 (9/70) royalty is based on "amount realized" except for gas used by the lessee. Shell computed royalties in the same manner under all these provisions, however, and contends that they all have the same legal effect.

The gas from these fields is "sour"—it contains hydrogen sulfide. Before the gas can be put into the mainstream of commerce it must be processed. Rather than attempt to find someone to process the gas, Shell decided to do the processing itself. At its Thomasville plant, Shell treats the sour gas from the wells and recovers "sweet gas"—dry methane—and elemental sulfur.

Shell began efforts to market the gas from these fields in 1970. Shell sought buyers on the intrastate market because it wished to avoid restrictive federal regulations on interstate sales. *See* 15 U.S.C. §§ 717-717z (1982); 42 U.S.C. § 6399 (1976). After extensive negotiations with several potential buyers, Shell contracted with MisCoa,[2] of Yazoo City, Mississippi, to sell up to 46,667 thousand cubic feet

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2. MisCoa is a partnership of two Mississippi corporations, Mississippi Chemical Corporation and Coastal Chemical Corporation.

(Mcf) a day to MisCoa for 53 cents per Mcf, with an increase to 54.59 cents after 15 million Mcf were delivered, and price escalation of three percent a year thereafter. On May 23, 1972, Shell contracted to sell excess gas to Mississippi Power and Light (MP & L) for 45 cents per Mcf, with escalation of one percent a year. Both contracts appear to have been the best available at the time. Both contracts provide that title to the gas passes in the field, when the gas is still sour. But in fact the buyer does not take control of the gas until it is processed and "redelivered". In the MisCoa contract the measurements of quality and quantity that determine how much MisCoa pays are not made until the gas is "redelivered", as sweet gas, in Yazoo City. The MP & L contract provides for "redelivery" near the Thomasville plant. Both contracts state that the sale price includes "substantial consideration" for Shell's agreement to gather and process the gas and, in MisCoa's case, to assume the risk of loss during transportation to Yazoo City. Apparently, the parties agreed that title would pass at the wells so that the parties could avoid state regulations on pipelines. But the passage of title at the wells is also relevant to the royalty clauses in Shell's leases. Because the gas is supposedly sold "at the wells", Shell has paid royalties based on the actual revenues received from its sales of sweet gas and sulfur,[3] rather than on market value. Shell deducts from these royalties a substantial portion of the costs of processing the gas.

The lessors filed this class action on December 27, 1974, alleging that Shell computed royalty payments im-

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3. It is clear, and Shell does not contest, that the royalty for elemental sulfur produced from sour gas is covered by the gas royalty clauses rather than the clauses providing for royalties on "mined" minerals. *Scott Paper Co. v. Taslog, Inc.*, 5 Cir.1981, 638 F.2d 790.

properly.[4] The case was tried without a jury in November and December 1979. On May 3, 1982, the court issued its findings of fact and conclusions of law. The court found that Shell properly deducted the costs of processing from the royalty payments and properly based royalties for gas sold on the actual revenues realized since title to the gas passed from Shell to MisCoa at the wells. The court also rejected the plaintiffs' claim that Shell breached its duty to market the gas.[5] The court did find that Shell should have paid royalties, based on current market value, for gas *used* in off-lease operations, but rejected the plaintiffs' evidence on market value and asked the plaintiffs to provide further evidence. Without explanation, the court also rejected the plaintiffs' claims for royalties on gas used by Shell at the Thomasville plant.

Upon the plaintiffs' motion the court issued a final judgment on the claims decided, and certified the case for appeal under Federal Rule of Civil Procedure 54(b).

II. *Jurisdiction*

[1] Shell argues that we do not have jurisdiction over this appeal, on the ground that the claims not decided are inseparable from those certified. This is plainly incorrect. The district court's decision effectively disposed of all the issues except the amount of extra royalty owed by Shell. Litigation remains on only one claim, the royalties due on off-lease use of gas by Shell. One fact—

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4. The plaintiffs also alleged that Shell violated the Sherman Act, 15 U.S.C. §§ 1-2 (1982), by engaging in an illegal restraint of trade in, and monopolization of, the gas and sulfur markets in the Thomasville, Piney Woods, and Southwest Piney Woods fields. The plaintiffs did not go forward with proof on this claim and the district court dismissed it. The plaintiffs do not appeal this decision.

5. The plaintiffs do not appeal this ruling.

the market value of gas—is relevant to several claims, but this does not make the claims inseparable. Alternatively, Shell argues that the district court abused its discretion in certifying the appeal. This contention is meritless. The only thing left for the plaintiffs to do in the district court is to present lengthy evidence on the market value of the small amount of gas Shell used in off-lease operations. The plaintiffs' potential recovery would not justify the expense of this proof. We think that the district court acted wisely and in the interests of "sound judicial administration" in certifying the case at this stage. *See Curtiss-Wright Corp. v. General Electric Co.*, 1980, 446 U.S. 1, 9, 100 S.Ct. 1460, 1466, 64 L.Ed.2d 1, 12; *Skinner v. W.T. Grant Co.*, 5 Cir.1981, 642 F.2d 981, 983-84.

Shell also argues that the certification reserves some issues other than the amount of Shell's liability on the off-lease use claim—for example, whether "market value" means "current market value" in the context of sold gas as well as used gas. We understand this appeal to present all the issues except two factual questions: the market value of the gas and the amount of gas for which royalties are due.

III. *The Meaning of the Royalty Clauses*

The basic issues underlying this case are the meaning of "market value" and "sold at the wells" in a royalty clause and the propriety of deducting processing costs from the lessors' royalties. The royalty clauses prescribe different formulas for the calculation of royalties depending on whether the gas is sold or used, and on whether the sale or use is "at the well". Consideration of these distinctions guides our resolution of all the issues in this case.

In both the Commercial and Producers 88-D9803 royalty clauses, the royalty on gas "sold at the well" is

based on amount realized from sale, while on other gas the royalty is based on "market value at the well."[6] In interpreting similar provisions, courts have struggled with perceived grammatical ambiguities. In *Exxon Corp. v. Middleton*, 1981, Tex., 613 S.W.2d 240, for example, the court held that "off the premises" modified both "sold" and "used" in a lease form similar to the D9803; the court therefore held that "at the wells", which is used in apparent contrast to "off the premises", means "on the [leased] premises" rather than "in the field of production". Because the gas was in fact placed in the buyer's control at the time title passed, *Middleton* did not question that the gas was "sold" at that point. Here, however, the lessors argue that the place where title formally passes is not necessarily the place where gas is "sold" for the purposes of the royalty provisions. Resort to grammatical parsing is less instructive here than is a consideration of the purpose of the gas royalty clause, taken as a whole.

Commentators have suggested several reasons for differentiating between gas "sold at the well" and other gas in determining royalty. One author states that "gas is 'sold at the well' when the gas purchaser bears the expense of connecting his lines to the well". In such a case, the sale price is a proper measure of value. On the other hand, if the lessee pays for transportation, he should be compensated for it; the costs of transport are, therefore, deducted from the sale price to arrive at "value at the well". Note, Henry v. Ballard & Cordell Corp.: *Louisiana Chooses a Point in Time in the Market Value Gas Royalty Controversy*, 43 La.L.Rev. 1257, 1267 (1983). Similarly, Professor Owen L. Anderson suggests that "market value at

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6. By contrast, the Producers 88 (9/70) royalty clause treats all gas sold by lessee the same: royalty is based on "amount realized by lessee, computed at the mouth of the well"; only on gas used by the lessee is royalty based on market value.

the well" is determined by deducting transportation costs from the *value* (not the sale price) at the place of sale. Anderson, *David v. Goliath: Negotiating the "Lessor's 88" and Representing Lessors and Surface Owners in Oil and Gas Lease Plays*, 27 Rocky Mtn. Min.L.Inst. 1029, 1120 (1982).

[2] These explanations are helpful, but not complete: in addition to transportation, other actions by the lessee away from the wellhead may affect the value of the gas when sold. In this case MisCoa paid, not for sour gas at Rankin County wells, but for sweet gas delivered to Yazoo City. Transportation and processing both increased the value of the gas to MisCoa. *See* Harmon, *Gas Royalty —Vela, Middleton, and* Weatherford, 33 Inst. on Oil & Gas L. & Tax'n 65 (1982). Harmon states,

> "The most logical conclusion is that the oil and gas industry understood that the term 'market value' in this gas royalty clause would be something less than the gross proceeds received for the sale of the gas, where the gas was sold and the delivery point was some distance removed from the field in which the wells were located. In such circumstances the royalty on gas would be based on market value—the amount for which the gas could have been sold in the field, less compression, gathering, and treating costs. When the gas was 'sold at the wells,' whether the delivery point was on or off the lease, the 'amount realized' from the sale would be the basis of any royalty payment."

Id. at 69. For reasons discussed in this opinion we disagree with Harmon's conclusion that "market value" may not exceed actual proceeds. But we do find his discussion instructive on the purpose of the distinction between

gas sold at the well and gas sold off the lease. We conclude that the purpose is to distinguish between gas sold in the form in which it emerges from the well, and gas to which value is added by transportation away from the well or by processing after the gas is produced. The royalty compensates the lessor for the value of the gas at the well: that is, the value of the gas after the lessee fulfills its obligation under the lease to produce gas at the surface, but before the lessee adds to the value of this gas by processing or transporting it. When the gas is sold at the well, the parties to the lease accept a good-faith sale price as the measure of value at the well. But when the gas is sold for a price that reflects value added to the gas after production, the sale price will not necessarily reflect the market value of the gas at the well. Accordingly, the lease bases royalty for this gas not on actual proceeds but on market value.

"At the well" therefore describes not only location but quality as well. Market value at the well means market value before processing and transportation, and gas is sold at the well if the price paid is consideration for the gas as produced but not for processing and transportation.

IV. *Point of Sale*

Based on the foregoing discussion, we conclude that the gas sold by Shell was not "sold at the well", within the meaning of the lease, even though the sale contracts provide that title to the gas passes on or near the leased premises. Under the MisCoa contract, for example, title passes in the field but the sale price is not determined until after the gas is processed and transported to Yazoo City. The sour gas is metered in the fields, but this measurement appears to be of little significance. MisCoa

effectively pays only for the amount of sweet gas delivered at Yazoo City, and pays a price commensurate with the value of sweet gas at the time the contract was made. The contract explicitly states that the sale price includes consideration for processing and for Shell's assuming the risk of loss during transportation to Yazoo City.

[3] The District Court based its holding that the gas was sold in the fields on the provisions of the Uniform Commercial Code. The UCC applies to sales of natural gas, and therefore governs the sale contract between Shell and MisCoa. Miss.Code Ann. § 75-2-107(1) (1981). The parties to a sale contract may arrange for passage of title in any manner they choose. *Id.* § 75-2-401(1). Title may pass although the quantity of goods has not yet been determined, *id.* § 75-2-105(4), and the quality not yet brought up to contract specifications, *id.* § 75-2-501(1). There is no need to question that, under the sale contract, title passed in the fields. But the simple passage of title does not control whether the gas was "sold at the well" within the meaning of the leases. In the leases, "at the well" refers to both location and quality: gas is "sold at the well" only if its value has not been increased before sale by transportation or processing. This is plainly not the case here.

[4] To interpret the leases otherwise would place the lessors at the mercy of the lessee. The lessors had no say in Shell's choice of where to put the passage of title. Their interests were either irrelevant or adverse to Shell's. Shell and its buyers wanted to avoid state pipeline regulations; but their decision to do so had the effect of placing the "point of sale" on the lease, thereby avoiding Shell's obligation to pay royalties based on market value. The opportunity for manipulation is apparent. Harmon, for example, counsels producers to "attempt to

obtain appropriate contract amendments which would move the sales point onto the premises of each lease from which gas delivered under the contract is produced" to avoid payment of market value royalty. 33 Inst. on Oil & Gas L. & Tax'n at 95. We note as well the strange results that may occur if the determination of whether gas is "sold at the well" turns solely on the place where title passes. For example, if gas from several leases is delivered at a single point in the fields some lessors may be entitled to market value royalty while others receive proceeds royalty; similarly, gas produced from one lease through a directional well drilled on another lease would be sold "off the lease" even if delivered at the wellhead itself. *See* Holliman, *Exxon Corporation v. Middleton: Some Answers But Additional Confusion in the Volatile Area of Market Value Gas Royalty Litigation*, 13 St. Mary's L.J. 1, 47-49 & 48 nn. 185-86. If the place of delivery is controlling, it makes "[t]he happenstance of the point of delivery . . . very significant". Hoffman, *Pooling and Unitization: Current Status and Developments*, 33 Inst. on Oil & Gas L. & Tax'n 245, 265 (1982). We are convinced that Mississippi law does not allow the lessors' rights under an oil and gas lease to turn on such "happenstance", especially when the point of delivery is in the lessee's control.

[5, 6] Mississippi law looks beyond the formal passage of title when the interests of persons not party to the contract are at stake. *State ex rel. Patterson v. Pure-Vac Dairy Products Corp.*, 1964, 251 Miss. 472, 170 So.2d 274, *appeal dismissed*, 1965, 382 U.S. 14, 86 S.Ct. 46, 15 L.Ed.2d 9. *Pure-Vac* held that a dairy could not evade state milk regulations by changing its sale contracts to provide that title passed at the dairy's loading docks in Tennessee, since the milk was delivered by the dairy

to Mississippi customers who paid only for what they received in Mississippi. The court held that the sale occurred in Mississippi and could therefore be regulated.[7] We agree with Shell that *Pure-Vac* does not require us to hold that title to the gas did not pass in the fields. In *Pure-Vac* the court rejected a sham devised specifically to evade state regulation. Here the district court found no bad faith. We do not hold that the gas sale contract was ineffective to pass title in the fields. But *Pure-Vac* does mean that agreement between a buyer and seller on a place for title to pass need not be conclusive for the purposes of laws extrinsic to the contract. Similarly, the reference in the lease to "sold at the well" need not be controlled by the point at which title passes in the sale contract. We therefore conclude that the gas was not "sold at the well" within the meaning of the Commercial and Producers 88-D9803 leases.

V. *The Meaning of Market Value*

Because the gas was not "sold at the well", the royalties under the Commercial and Producers 88-D9803 leases must be computed on the basis of "market value at the well" rather than actual proceeds. The district court reached the issue of what market value means in that it held that Shell owed market value royalty under all the leases for gas *used* in off-lease operations. Shell did not appeal this holding and, perhaps because of the small amount of money

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7. The precise holding of *Pure-Vac* was questioned in *Schwegmann Bros. Giant Super Markets v. Louisiana Milk Comm'n*, 1973, M.D.La., 365 F.Supp. 1144, *aff'd*, 1974, 416 U.S. 922, 94 S.Ct. 1920, 40 L.Ed.2d 279, which held that the Pure-Vac Dairy's sales to Louisiana customers (on terms identical with those made to Mississippi customers) were consummated in Tennessee and could therefore not be regulated by Louisiana. This in no way affects the principle of *Pure-Vac* that the parties to a sale contract may not conclusively extinguish the rights of persons not party to the sale simply by selecting a place for passage of title.

involved, did not appeal the district court's further holding that "market value" means value when the gas is delivered rather than when the sale contract is made. The plaintiffs contend that this holding is not before us now. Shell, however, contends that the district court's definition of market value applies only to "used" gas, not to "sold" gas. We see nothing in the district court opinion to suggest this result, and we reject Shell's argument that "market value at the well" has different meanings in different clauses of the same sentence. Shell's argument is enough, however, to put the meaning of market value before us, at least with respect to royalties on gas sold by Shell. The district court certified this appeal to dispose of all of the issues except the amount of damages owed by Shell. We affirm the district court's holding.

The meaning of "market value" has been at the fore of lease litigation ever since the price of gas began to increase at a rate much faster than the price escalation clauses of existing gas contracts contemplated. As long as the price of gas increased at a rate substantially equivalent to the inflation rates provided in sale contracts, it made little difference whether current market value or actual proceeds formed the basis of royalty payments: the check to the lessor was the same. But when the price of gas began to rise much faster than anticipated, this distinction became of the utmost moment to lessors and lessees.

Until the 1970s the authority was clear that "market value" referred to market value at the time of production and delivery rather than when the applicable sale contract was made. *See, e.g., Wall v. United Gas Public Service Co.*, 1934, 178 La. 908, 913, 152 So. 561, 563; *Foster v. Atlantic Refining Co.*, 5 Cir.1964, 329 F.2d 485, 489-90 (Texas

law); *Texas Oil & Gas Corp. v. Vela*, 1968, Tex., 429 S.W. 2d 866. This rule has been upheld more recently in, e.g., *Lightcap v. Mobil Oil Co.*, 1977, 221 Kan. 448, 562 P.2d 1, 11, *cert. denied*, 1977, 434 U.S. 876, 98 S.Ct. 228, 54 L.Ed.2d 156; *Montana Power Co. v. Kravik*, 1978, 179 Mont. 87, 586 P.2d 298, 302; *Exxon Corp. v. Middleton*, 1981, Tex., 613 S.W.2d 240, 244-45. This line of cases, to which we refer as the *Vela* rule, was uncontradicted until very recently. A recent line of cases, however, holds that "market value" is equivalent to the price assigned in the sale contract, at least as long as that contract was made prudently and in good faith. The first case so to hold was *Tara Petroleum Corp. v. Hughey*, 1981, Okla., 630 P.2d 1269. *Tara* has been followed in *Hillard v. Stephens*, 1982, 276 Ark. 545, 637 S.W.2d 581, 583, and *Henry v. Ballard & Cordell Corp.*, 1982, La., 418 So.2d 1334.[8]

The *Vela* rule is based principally on the doctrine that a gas sale contract is only executory until the gas is delivered, *Martin v. Amis*, 1926, Tex.Com.App., 288 S.W. 431, 433, and on the premise that the distinction made by the lease between market value and amount realized is meaningless under the *Tara* rule. *Tara*, on the other hand, found the *Vela* rule unfair because, when prices are rising, the *Vela* rule requires the lessee to pay the lessor an increasing percentage of the total revenues.

Shell argues that *Simpson v. United Gas Pipe Line Co.*, 1944, 196 Miss. 356, 17 So.2d 200, repudiated the rule that a gas sale contract is an executory contract. According

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8. In *Scott Paper Co. v. Taslog, Inc.*, 5 Cir.1981, 638 F.2d 790, the appeals court affirmed the lower court's use of sales revenues (less processing costs) as a measure of "market price", but this was because the parties had agreed to this method in a division order. *Id.* at 797; *cf. Simpson v. United Gas Pipe Line Co.*, 1944, 196 Miss. 356, 17 So.2d 200, discussed in the text of this opinion.

to Shell, *Simpson* held that all the gas on the leased premises is sold when the sale contract is made; market value therefore means market value at the time of the contract; and since Shell's sale contracts were made in good faith they are conclusive evidence of the market value of the gas at that time. This argument rests on a misreading of *Simpson*. *Simpson* held that the plaintiff lessor was entitled only to royalties based on the contract price, because the lessor had signed a division order agreeing to take royalties based on that price. The court held that the lessor benefitted from the division order because the order facilitated a long-term gas contract under which the lessor "got an immediate sale for the gas". *Id.* at 366, 17 So.2d at 202. The court was concerned only with whether the division order was supported by consideration. The reference to "immediate sale" had nothing to do with passage of title but simply meant that the long-term contract made further marketing efforts unnecessary and that royalty would begin to be paid immediately.

[7-9] We fully agree with the district court's conclusions that a gas sale contract is executory and that the sale is executed only upon production and delivery. Under section 75-2-105 of the Mississippi Code[9] the gas un-

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9. "(1) 'Goods' means all things (including specially manufactured goods) which are movable at the time of identification to the contract for sale other than the money in which the price is to be paid, investment securities (Chapter 8) and things in action. 'Goods' also includes the unborn young of animals and growing crops and other identified things attached to realty as described in the section on goods to be severed from realty (Section 2-107) [§ 75-2-107].

"(2) Goods must be both existing and identified before any interest in them can pass. Goods which are not both existing and identified are future goods. A purported present sale of future goods or of any interest therein operates as a contract to sell."

Miss.Code Ann. § 75-2-105 (1981).

derground is future goods; no particular gas is sold until it is identified—i.e., brought to the surface. The sale contracts are not transfers of an interest in land; accordingly, under section 75-2-107(1),[10] the contracts are contracts to sell and only become effective as sales when the gas is severed from the land. The logic of these provisions is clear. Under the leases, Shell has a *defeasible* interest in the gas underground. The most it could sell MisCoa or MP & L is that same defeasible interest: in effect, the right to possession of the gas if it is produced before Shell's lease terminates. The leases may terminate if Shell breaches implied or express covenants or if there is a cessation of production after the expiration of the primary term of the lease.[11] If the leases terminate, Shell would no longer have the power to deliver title to the gas. MisCoa might be able to sue Shell for a breach of *contract to sell*, but it would have no claim to the gas itself or to specific performance of the contract, because all title to the gas would have reverted to the lessors. Shell could not "sell" the gas to MisCoa, because a "sale" consists in the passing of title, *id.* § 75-2-106.

We therefore conclude that the gas was not sold until it was produced. The sale contract itself provides that title passes when the gas is delivered. Accordingly, the basis

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10. "(1) A contract for the sale of minerals or the like (including oil and gas) or a structure or its materials to be removed from realty is a contract for the sale of goods within this chapter if they are to be severed by the seller but until severance a purported present sale thereof which is not effective as a transfer of an interest in land is effective only as a contract to sell."

Miss.Code Ann. § 75-2-107(1) (1981).

11. Forfeiture by the lessee has traditionally been the most common remedy for breaches of the requirements of the lease. See 4 H. Williams, *Oil and Gas Law* § 681 (1981). *But see* Waldman, *The Demise of Automatic Termination*, 54 Okla.B.J. 2767 (1983) (forfeiture disfavored in recent Oklahoma cases).

of royalty should be "market value at the well" at the time of production and delivery, as the district court held.

We also find the district court's decision supported on other grounds. First, the explicit language of the leases distinguishes between gas sold at the well and gas sold off the lease, and between amount realized and market value. The *Tara* rule eliminates the differences: the lessor receives a royalty based on amount realized no matter where and in what form the gas is sold. To be sure, *Tara* states that the contract price is the market price only if the contract was made prudently and in good faith, and therefore the sale price is market value only in those circumstances. 630 P.2d at 1274. But the same is true of royalty under an "amount realized" clause. If the lessee makes a sale in bad faith, he breaches both his duty to deal in good faith with the lessor and his duty to market, and the lessor will not be bound to the contract price. *See Kretni Development Co. v. Consolidated Oil Corp.*, 10 Cir.1934, 74 F.2d 497, 500. Under *Tara*, therefore, any distinction between "market value" and "amount realized" is illusory.

[10] We also reject the interpretation advanced by Harmon and Lowe that market value may never exceed actual proceeds. These commentators suggest that market value simply means actual proceeds less processing expenses. *See* Harmon, 33 Inst. on Oil & Gas L. & Tax'n at 69; Lowe, *Developments in Nonregulatory Oil and Gas Law*, 32 Inst. on Oil & Gas L. & Tax'n 117, 146-47 (1981). Certainly a lease *may* provide for royalties based on proceeds less processing. But this result may be accomplished clearly and explicitly by stating that royalty is "one eighth of the amount realized from the sale of the gas less processing and transportation expenses", or even more simply, "one eighth of the amount realized by lessee, computed

at the well".[12] "Market value" as used in these leases is not equivalent to the formulations just recited, because it applies to royalties not only on gas sold at the well but also to gas *used*. There are no "proceeds" or "amount realized" for such gas. It strains language and credulity to argue that the "market value" of gas produced in 1977 and *not* sold to MisCoa is what the gas would have been sold for under a long-term contract made in 1972 rather than what the gas would be worth if sold on the open market when produced. Although it is conceivable that the single use of the term "market value" might require two different computational formulas when applied to two different types of gas, the more natural reading is that the term has the same meaning for both types of gas.

[11, 12] Moreover, Shell and those from whom it received leases by assignment were or should have been aware that "market value" had been held to mean value at the time of production both in old cases like *Wall* and in new cases like *Foster* and *Vela*. *Foster* was decided in 1964. *Vela* was decided by the Texas Court of Civil Appeals in 1966 and affirmed by the Texas Supreme Court in 1968. From the record it appears that no lease at issue here predates *Foster* and only a few predate *Vela*. Though not binding on Mississippi lessees, these decisions were widely discussed in the industry and should have alerted the lessees to the potential legal effect of the royalty clause. Shell certainly had ample opportunity to change the language if in fact it intended a "proceeds" lease. *Vela*, 429 S.W.2d at 871. It has long been doctrine that mineral leases are construed against the lessee and in favor

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12. The Producers 88 (9/70) royalty provision at issue in this case bases royalties on "one-eighth of the amount realized by lessee, computed at the mouth of the well". Shell and other lessees plainly knew how to draft a proceeds lease.

of the lessor.[13] *Frost v. Gulf Oil Corp.*, 1960, 238 Miss. 775 786, 119 So.2d 759, 761; 2 W. Summers, *Law of Oil and Gas* § 232 (perm. ed. 1959); 3 H. Williams, *Oil and Gas Law* § 628 (1981); 4 *id.* § 684. But our decision that market value means value rather than proceeds is not simply an instance of interpretation against the lessee.[14] It is rather a holding that, although the royalty clauses might have been less than lucid to laymen, they were quite readily understandable to those in the industry. Shell knew what a "market value" lease was and what a "proceeds" lease was. *See Lightcap v. Mobil Oil Corp.*, 1977, 221 Kan. 448, 457, 562 P.2d 1, 8; *Hillard v. Stephens*, 1982, Ark., 637 S.W.2d 581, 587 (Hickman, J., dissenting). Shell "cannot expect the court to rewrite the lease to [its] satisfaction". *Foster*, 329 F.2d at 490.[15]

[13] Shell asserts that "[r]oyalty payments based upon good faith contract prices have always been the

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13. In one oil-producing state (Oklahoma) this doctrine has not been applied in many years, but even in Oklahoma the doctrine has never been overruled. *See* Waldman, *The Demise of Automatic Termination*, 54 Okla.B.J. 2767 (1983). Elsewhere it is still clear that lessees will be held responsible for the leases they procure. This rule is justified even if some lessors have better legal advice and more of a role in negotiations today than they did at one time, because lessees still have greater expertise in and knowledge of the industry and the law surrounding it, still provide the lease forms, and still have bargaining advantages that limit the ability of lessor a to take an active role in the making of leases. *Id.* at 2773.

14. If the price of gas declines, a market value royalty clause would benefit a lessee who has contracted to sell gas at a favorable price. *See, e.g.*, Note, 43 La.L.Rev. at 1266 n. 49.

15. For the same reason we reject the argument, accepted in *Henry*, 418 So.2d at 1338, that the "ultimate objective of the royalty provisions of a lease is to fix the division between the lessor and lessee of the economic benefits anticipated from the development of the minerals." If the purpose were to fix royalty at a permanent percentage of lessees' profits, the lessee could certainly devise language to say so. We hold to the contrary that the market value clause serves in part to protect the lessor from bad bargains by the lessee.

custom in Mississippi". Brief for Appellee at 42. The district court did not make a finding to this effect and we doubt its universal truth. In a recent Louisiana case, Shell itself stipulated that market value royalty was determined by current market value. *Shell Oil Co. v. Williams, Inc.*, 1983, La., 428 So.2d 798, 799. Of course, Shell is not bound by this stipulation in this case, but *Williams* does indicate that current market value is not unheard of as a basis for royalty in Shell's own leases, even in a state where the same assertion of "custom" was made, and where "market value" has now been held to mean contract price, *see Henry*, 418 So.2d at 1340-41. This allegation of "custom" is of course self-serving. The payment of royalties is controlled by lessees, and lessors have no ready means of ascertaining current market value other than to take lessees' word for it. *See* M. Merrill, *Covenants Implied in Oil and Gas Leases* 216 (2d ed. 1940). The formula for determining royalty and the statements issued to lessors may be, as in this case, complex; it is likely that many lessors have never known just what basis lessees were using. For a practice to be legally relevant custom, both parties to the contract must have actual or presumed knowledge of the practice. *Meridian Star v. Kay*, 1951, 211 Miss. 536, 545, 52 So.2d 35, 38. Those not engaged in an industry will not be presumed to know that words which have common meanings outside the industry have a different meaning inside it. *New York Life Ins. Co. v. Nessossis*, 1940, 189 Miss. 414, 425, 196 So. 766, 768. Market value in these leases is most easily understood to mean current value: the lessors cannot be presumed to know that Shell and other producers made a practice of basing their royalty payments on a different criterion. We will not find "custom" binding on lessors from a practice within the control and understanding only of the lessees.

The most important rationale underlying the *Tara* rule is the concern that it is unfair to require the lessee to pay increasing royalties out of a constant stream of revenues. The reasoning is as follows: the lessee has a duty to market the gas; gas is customarily sold in long-term contracts; the lessee is thus forced by his duty to the lessor to enter into a long-term contract but then sees his profits whittled away as the market price of gas rises. *See Tara*, 630 P.2d at 1273. The *Tara* court reasoned further that its rule was not unfair to lessors, because they still receive royalties and are protected by the lessee's obligation to make a reasonable sale contract. *Id.* at 1274.

We appreciate that a lessee may find itself economically disadvantaged when its royalty obligations increase while its sale revenues remain constant. But this is no more than the risk assumed by every business venturer who undertakes the role of middleman. In this case it appears that Shell chose to market its gas to MisCoa at an initial price higher than any previously negotiated in the United States, but with a low annual escalation rate. Shell might instead have accepted a lower initial price but reserved the opportunity to redetermine the price at later intervals. Transcript at 1658-72. The district court held that Shell's decision was not a breach of the lease-created covenant to market, since the choice of the MisCoa contract was a prudent and reasonable one. But prudence does not relieve Shell of its obligations under the lease. To say that the gas contract was what a "prudent operator" would have negotiated under the circumstances begs the question. The question is whether the operator should be saved from loss of profits simply because it acted prudently and the world economy acted adversely. If Congress or the Mississippi legislature wishes, it may establish a relief fund or create tax credits to assist the unfor-

tunate lessees. It is not the function of the courts, construing and enforcing contracts under state law, to intervene on behalf of producers experienced in the petroleum industry, and thereby deprive lessors of their legitimate contractual expectations. "Stripped of all its trimmings [the "fairness" argument] is simply: We cannot comply. This is no answer . . . . The fact that the ascertainment of future market price may be troublesome or that the royalty provisions are improvident and result in a financial loss to [the lessee] 'is not a web of the Court's weaving.' " *Foster*, 329 F.2d at 490 (footnote omitted).

We conclude that the *Tara* rule is unfair to lessors. A landowner may decide to accept a royalty based on a smaller fractional share of market value, rather than to hold out for a larger share of proceeds, because of an expectation that the market value will rise. If the courts then intervene and declare that "market value" is the same as "proceeds", this expectation is destroyed. Moreover, the lessor has no means with which to persuade the lessee to renegotiate the lease to reflect the changed legal rule. This is illustrated by the following hypothetical. A landowner is offered leases by two producers. The first offers a ⅛ market value royalty; the second offers a 1/6 proceeds royalty. The landowner decides to lease to the first operator, because he thinks the market value of gas will rise enough to compensate for the lower fractional share. This is a business risk: if the price does not rise enough, the lessor loses money. If, however, the price rises as the lessor thought, the lessor has won his bet, just as the lessee has lost his gamble that the price would not rise; and the lessor ought to profit. But if the *Tara* rule intervenes, it takes away the lessor's legitimate expectation of market value royalties without any compensation at all. The lessor would be frozen into ⅛

proceeds royalties on a long-term low-price sales contract made by his lessee.

By contrast, under the *Vela* rule, which we adopt, the lessor's royalties increase according to the provisions of the lease. At some point the lessee may find continued operation so unprofitable that it is more economical to cease production. At this point the lessor has a strong incentive to renegotiate the lease, because a cessation of production will mean the end of all royalties until another lessee can be found, and the present lessee has a comparative advantage over others in that it has the necessary facilities already in place. The lessee's buyers will have an incentive to renegotiate the sale contracts rather than seek new and more expensive sources of gas.[16]

In short, the rule proposed by Shell would deprive the lessors both of their expected market value royalties and of any opportunity to recover some of these royalties through renegotiation of the lease. By enforcing the clear terms of the market value lease, we preserve those expectations and provide opportunities and incentives for the parties to make new contracts more nearly reflecting current economic conditions.

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16. In these renegotiations, for example, the lessor might agree to take 1/6 of actual proceeds instead of 1/8 of market value; or the buyer might consent to pay a price nearer to market price, or to compensate the lessee for royalties. *See* Harmon, 33 Inst. on Oil & Gas L. & Tax'n at 95; Anderson, 27 Rocky Mtn.Min.L.Inst. at 1112-13.

We note that the Shell-MisCoa sale contract provides that Shell has the right to abandon operation of the Thomasville plant and its obligation to sell gas to MisCoa, upon six months' notice, if Shell becomes "unable to conduct the operation of such Plant and wells on a continuingly profitable basis". During the six-month notice period, Shell and MisCoa "agree to negotiate in good faith in an effort to reach acceptable supplemental arrangements whereby [Shell], or an assignee of [Shell], will continue beyond such six (6) months' period to operate the Thomasville Plant and wells serving such Plant and to deliver gas to Buyer". Exhibit P-18(a), § 19.4, at 42-43.

Accordingly, we affirm the district court's holding that market value means current market value at the time of production.

VI. *Proof of Market Value*

Max Powell, the plaintiffs' expert witness on the issue of market value, based his estimates of market value on the average of the top three prices for gas sold in seven counties that he had previously selected as a relevant market area. This technique is the same one that Powell used, and that the court approved without contest, in *Butler v. Exxon Corp.*, 1977, Tex.Civ.App., 559 S.W.2d 410. It is similar to the method used in *Exxon v. Middleton*, 1981, Tex., 613 S.W.2d 240. The district court, however, found Powell's testimony unpersuasive. Shell challenged Powell's data on the ground that sales of sweet gas are not comparable with sales of sour gas. The district court rejected this argument, noting that the processing costs, which reflect the price of converting the sour gas to sweet gas, are deducted from royalty. But the court found Powell's data noncomparable because of "[t]he unprecedented volume, deliverability and reserves of production" in the Thomasville-Piney Woods fields. The court devised its own formula:

> "Once the relevant market area is defined and comparable sales are identified, the Court concludes that computation of market value should be made by the division of net sales receipts derived from sales of comparable gas (after necessary adjustments for variances in Btu content and compression changes) by the total volume sold."

539 F.Supp. at 987. The court made no findings on market value and directed the parties to consult the court for directions on further proof. *Id.*

[14, 15] Although the district court did not certify this issue for appeal, the plaintiffs now ask us to order the district court to use Powell's method for determining market value on remand. This we decline to do. Market value is a question of fact, and it is up to the factfinder to determine the probative strength of relevant evidence. The plaintiffs contend that Powell's evidence was the only evidence on the issue, but the Shell-MisCoa contract, while not *conclusive* evidence of market value, was also plainly *relevant* to the issue. *See* E. Brown, *The Law of Oil and Gas Leases* § 6.09, at 6-66 to 6-67 (1983). The district court found that the sales used by Powell were made under conditions different enough to weaken their persuasiveness. The court was within its discretion to seek evidence of sales it considered more nearly "comparable".

[16] A number of courts have struggled with the question of how to prove market value. *See, e.g., Exxon v. Middleton*, 1981, Tex., 613 S.W.2d 240; *Montana Power Co. v. Kravik*, 1978, 179 Mont. 87, 586 P.2d 298; *Weymouth v. Colorado Interstate Gas Co.*, 5 Cir.1966, 367 F.2d 84. The only general rule that emerges from these cases is that the method of proof varies with the facts of each particular case. In determining market value at the well, the point is to determine the price a reasonable buyer would have paid for the gas at the well when produced. Comparable sales of gas at other wells may be used to do this. Another method is to use sales of processed gas and deduct processing costs. Yet another relevant measure is the one proposed by Shell, the actual sale price of the gas less costs. "This is the least desirable method of determining market price", *Montana Power*, 586 P.2d at 303-04, but its persuasiveness is a matter for the factfinder.

[17, 18] Completely comparable sales are not likely to be found.[17] Sales that have some different characteristics must be considered. "[O]bjections against uncomparable

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17. Courts have identified a wide range of factors that may affect the price of natural gas. *See, e.g., Hugoton Prod. Co. v. United States*, 1963, 315 F.2d 868, 161 Ct.Cl. 274, listing the following relevant factors:

> "(a) The volume available for sale. Generally the greater the volume or reserves, the greater the price the seller could command.
>
> "(b) The location of the leases or acreage involved, whether in a solid block or scattered, and their proximity to prospective buyers' pipelines.
>
> "(c) Quality of the gas as to freedom from hydrogen sulphide in excess of 1 grain per 100 cubic feet.
>
> "(d) Delivery point.
>
> "(e) Heating value of the gas.
>
> "(f) Deliverability of the wells. The larger the volume that could be delivered from a reserve, the greater the price the seller could command.
>
> "(g) Delivery or rock pressure. The higher the pressure, the less compression for transportation is required."

315 F.2d at 894-95. *Exxon v. Middleton* also contains a thorough discussion of the factors affecting market value, including the following:

> "Market value may be calculated by using comparable sales. Comparable sales of gas are those comparable in time, quality, quantity, and availability of marketing outlets. *Vela, supra.*
>
> "Sales comparable in time occur under contracts executed contemporaneously with the sale of the gas in question. Sales comparable in quality are those of similar physical properties such as sweet, sour, or casinghead gas. Quality also involves the legal characteristics of the gas; that is, whether it is sold in a regulated or unregulated market, or in one particular category of a regulated market. Sales comparable in quantity are those of similar volumes to the gas in question. To be comparable, the sales must be made from an area with marketing outlets similar to the gas in question. Gas from fields with outlets to interstate markets only, for instance, would not be comparable to gas from a field with outlets only to the intrastate market."

613 S.W.2d at 246-47 (footnote omitted).

sales, irrelevancies and unreliable hearsay [go] to the weight which the [factfinder] . . . should attach to the expert's opinion, and the protection to the other side as has always been true under our system [is] cross examination." *Weymouth*, 367 F.2d at 91. Especially when the court is factfinder, the court as well as counsel may question the expert opinions. But it should not dismiss fairly comparable sales out of hand because of certain incomparable qualities. The district court stated that there was a "lack of relevant evidence addressing comparability", 539 F.Supp. at 987. The evidence produced by plaintiffs may, in the opinion of the court, have been insufficient, but it was plainly *relevant*. The plaintiffs produced evidence suggesting that, while some factors differentiate the Thomasville-Piney Woods wells from the wells upon which Powell based his data, those factors (abundance and availability) would *increase*, not decrease, the value of the plaintiffs' gas. It was, of course, for the court as factfinder to accord this testimony such weight as it saw fit, and to seek better information as well. We therefore reject the plaintiffs' request that on remand we mandate the use of the Powell formula as the exclusive measure of market value. But if, on remand, the search for better measures of market value at the well proves unsuccessful or inordinately burdensome, we think it the duty of the trier of fact to decide the question as best it can on the basis of the evidence that is presented. The plaintiffs must meet their burden of proof and produce sufficient relevant evidence to support their contentions. Having provided such evidence they should not be faced with the impossible task of establishing market value with absolute certainty or perfection. *See* 3 H. Williams, *Oil and Gas Law* § 650.3 (1981). It is Shell's responsibility to rebut the plaintiffs' evidence and provide evidence of its own

to support its contentions. The decision is for the finder of fact, but the decision is made by balancing, not by erecting an insuperable barrier to relevant evidence.

VII. *Processing Costs*

[19] The gas from these fields is extremely sour. It is an expensive proposition to convert the raw gas into marketable sweet gas and elemental sulfur and to transport the gas and sulfur to the buyers. Shell has passed on to the royalty owners a proportion of these costs, as determined by complex formulas that compensate Shell for expenses and capital investment. The plaintiffs argue that this is improper, since a royalty interest is "not chargeable with any of the costs of discovery and production", *Mounger v. Pittman*, 1959, 235 Miss. 85, 86-87, 108 So.2d 565, 566. They cite authority for the proposition that "production" includes the lessee's marketing efforts and that therefore any costs necessary to make gas marketable are to be borne exclusively by the lessee. *See West v. Alpar Resources, Inc.*, 1980, N.D., 298 N.W.2d 484; *Sterling v. Marathon Oil Co.*, 1978, 223 Kan. 686, 576 P.2d 635; *Schupbach v. Continental Oil Co.*, 1964, 193 Kan. 401, 394 P.2d 1; *Gilmore v. Superior Oil Co.*, 1964, 192 Kan. 388, 388 P.2d 602; *California Co. v. Udall*, D.C.Cir.1961, 296 F.2d 384; 3 E. Kuntz, *Law of Oil and Gas*, § 40.5 (1967); M. Merrill, *Covenants Implied in Oil and Gas Leases* 212-18 (2d ed. 1940). They argue that leases are construed against the lessee and that, in the absence of specific language authorizing deductions, no deductions may be permitted.

Shell responds, and the district court held, that production ends when the gas is extracted from the earth. Expenses incurred after production may be charged against royalty computed "at the well". 3 H. Williams, *Oil and Gas Law* § 645 (1981). Accordingly, the costs of processing and transportation may be deducted.

We agree with Shell that the specification in the leases that royalty is computed "at the well" controls. In Part III of this opinion, we discussed the purposes of distinctions between "amount realized" and "market value at the well". We concluded that "at the well" refers not only to the place of sale but also to the condition of the gas when sold. "At the well" means that the gas has not been increased in value by processing or transportation. It has this meaning in conjunction with "value" or "amount realized" as well as with "sold". The lessors under these leases are therefore entitled to royalty based on the value or price of unprocessed, untransported gas. *Freeland v. Sun Oil Co.*, 5 Cir.1960, 277 F.2d 154, 157. On royalties "at the well", therefore, the lessors may be charged with processing costs, by which we mean all expenses, subsequent to production, relating to the processing, transportation, and marketing of gas and sulfur.

We emphasize, however, that processing costs are chargeable only because, under these leases, the royalties are based on value or price at the well. Processing costs may be deducted only from valuations or proceeds that reflect the value added by processing. Thus, processing costs may not be deducted from royalties for gas "sold at the well", because the price of such gas is based on its value before processing.

[20] The function of processing costs in determining royalties based on "market value at the well" is to adjust for imperfect comparisons. As we discussed in Part VI of this opinion, the best means of determining the market value at the well of the plaintiffs' gas would be to examine comparable sales of *sour gas* at other wells in the area. Apparently there were no such sales. The next-best method is to examine sales of sweet gas and sulfur, to determine the market value of the products resulting

from processing at the Thomasville plant. Processing costs may then be deducted as an indirect means of determining what a buyer would have paid for the sour gas at the wellhead.

[21] Under the Producers 88 (9/70) royalty provision, "amount realized by lessee, computed at the mouth of the well", is the basis of royalty for *all* gas sold, not merely that sold at the well (as in the other leases at issue here). Under this clause, processing expenses are deducted from the amount realized from the sales of sweet gas and sulfur to arrive at the royalty basis. *See Holbein v. Austral Oil Co.*, 5 Cir.1980, 609 F.2d 206 (per curiam); *Kretni Development Co. v. Consolidated Oil Corp.*, 10 Cir. 1934, 74 F.2d 497.

[22] The plaintiffs argue that Shell is entitled to deduct at most costs of sulfur production, but not to make deductions against residue gas. We see no basis for this distinction. The lessors are entitled to gas royalty at the well. This means royalty based on the value or price of the sour gas before it is separated into marketable constituents. The value or sale price of the residue sweet gas reflects Shell's processing costs just as surely as does the value or price of the sulfur.

[23] We agree with the plaintiffs that the processing costs, under both the "market value" and "amount realized" provisions, must be reasonable. The plaintiffs charge that Shell's formulas allocate more of the costs to royalty interests than is justified. According to the plaintiffs, the district court failed to consider this issue. We are unable to determine whether it did. The district court's opinion makes no specific finding whether the formulas are reasonable, but the final judgment states that the court denied the claim for "improper and *excessive* charges made against . . . royalty interests". Record at 2019 (emphasis

added). The record would support a finding of reasonability, but since this case is to be remanded we leave the issue open for further consideration by the district court.

VIII. *Plant Fuel*

[24] Shell uses gas from the plaintiffs' leases for operations on other leases ("off-lease fuel") and at the Thomasville plant ("plant fuel"). The district court upheld the plaintiffs' claim for royalty on off-lease fuel; but without explanation it denied the claim for royalty on plant fuel. Record at 2020. Shell does not dispute that plant fuel is "gas used off the lease" within the meaning of all the royalty clauses. Its response is rather than any royalties paid for use of plant fuel can simply be charged back to the lessors as processing costs. "The futility of such an exercise," says Shell, "is readily apparent. It would clearly be a wash." Brief for Appellee at 25.

It seems to us that the validity of Shell's argument depends on the accounting method used. The plaintiffs strenuously, although confusingly, insist that it will not be a "wash". They point out that, under the plant-lease split employed by Shell, only a portion of the costs of processing are borne by royalty owners. Furthermore, the working interests bear the costs on $\frac{7}{8}$ of the gas produced. Another possibility is that the total additional royalty payments might equal the total additional charges to royalty, but that individual royalty owners might be entitled to more or less, depending on the particular well from which Shell takes the plant fuel in a given month. Finally, processing costs are not per se chargeable to market value royalty. They must be *reasonable* costs, and the market value of sour gas may be more or less in a given time period than the value of the finished products less processing expenses.

Even if Shell is right that it owes no extra royalties for plant fuel, we do not think that this would justify its practice. The lessors are entitled to have their royalty determined according to the provisions of the lease, not according to an ad hoc method adopted without their consent. The leases plainly call for market value royalty on gas used off the lease and the royalty should be determined on that basis. We therefore hold that plant fuel is gas used off the lease and the lessors are entitled to market value royalty on that gas. Shell may, however, treat the royalty payments as processing costs to be divided, as any other processing costs, among the various working and royalty interests.

IX. *Attorney Fees and Prejudgment Interest*

[25] The plaintiffs requested attorney fees and costs on the theory that Shell exhibited bad faith. They also requested prejudgment interest, under Mississippi law, on the theory that Shell acted in bad faith and was guilty of conversion. *See Home Insurance Co. v. Olmstead*, 1978, Miss., 355 So.2d 310; *Phillips Distributors, Inc. v. Texaco, Inc.*, 1966, Miss., 190 So.2d 840; *Ingram Day Lumber Co. v. Robertson*, 1922, 129 Miss. 365, 92 So. 289. The district court denied both requests. We affirm that holding. The plaintiffs made no showing that Shell acted in bad faith either before or during this litigation. Nor is there any basis for holding Shell guilty of conversion. "Conversion requires an intent to exercise dominion or control over property inconsistent with the true owner's rights." *Masonite Corp. v. Williamson*, 1981, Miss., 404 So.2d 565, 567. Shell neither intended to exercise nor exercised any control inconsistent with the lessors' rights. It had every right to take the gas; it simply failed to pay royalties according to the proper measure. This is breach of contract but it is not conversion.

Our affirmance on this issue is without prejudice to the right of the attorneys representing the plaintiff class to seek fees for their efforts on behalf of the class at the conclusion of this litigation.

X. *Conclusion*

We hold that "at the well" refers to gas in its natural state, before the gas has been processed or transported from the well. The gas sold by Shell under the MisCoa and MP & L contracts was therefore not "sold at the well" within the meaning of the leases. Accordingly, under some of the leases the plaintiffs are entitled to royalty based on market value for that gas. We hold that in the leases "market value" means the market value of the gas at the time the gas is produced and delivered. Because the leases call for royalty based on market value or price "at the well", royalty is based on the value or price of the gas before it is processed or transported. To determine the correct basis for royalty, processing and transportation costs may be deducted from values or prices established for processed and transported gas. We also hold that the plaintiffs are entitled to royalty on plant fuel, but Shell may include these royalties as processing costs. On remand, the district court may, in its discretion, seek more accurate measures of market value than the evidence of comparable sales already produced by the plaintiffs. If those efforts prove unsuccessful or unduly expensive, the court must determine market value based on the evidence already submitted. The evidence already produced by the plaintiffs on market value is clearly relevant, and Shell has the burden of rebutting that evidence and producing more accurate evidence of market value.

The judgment of the district court is AFFIRMED in part, REVERSED in part, and REMANDED for a determination of damages in accordance with this opinion.

APPENDIX B-1

(Filed November 15, 1984)

IN THE UNITED STATES COURT OF APPEALS
FOR THE FIFTH CIRCUIT

No. 82-4287

THE PINEY WOODS COUNTRY LIFE
SCHOOL, ET AL.,
Plaintiffs-Appellants,

vs.

SHELL OIL COMPANY,
Defendant-Appellee.

Appeal from the United States District Court for the
Southern District of Mississippi

**ON PETITION FOR REHEARING AND
SUGGESTION FOR REHEARING
EN BANC**

(Opinion March 8, 1984, 5 Cir., 198.., ... F.2d .....)

(November 15, 1984)

Before Brown, Wisdom and Johnson, Circuit Judges.

PER CURIAM:

(√) The Petition for Rehearing is DENIED and no member of this panel nor Judge in regular active service on the Court having requested that the Court be polled on rehearing en banc, (Federal Rules of Appellate Procedure and Local Rule 35) the Suggestion for Rehearing En Banc is DENIED.

(☐) The Petition for Rehearing is DENIED and the Court having been polled at the request of one of the members of the Court and a majority of the Circuit Judges who are in regular active service not having voted in favor of it, (Federal Rules of Appellate Procedure and Local Rule 35) the Suggestion for Rehearing En Banc is also DENIED.

(☐) A member of the Court in active service having requested a poll on the reconsideration of this cause en banc, and a majority of the judges in active service not having voted in favor of it, rehearing en banc is DENIED.

Clerk's Note: See FRAP and Local Rules 41 for Stay of the Mandate.

ENTERED FOR THE COURT:

/s/ Sam Johnson
United States Circuit Judge

APPENDIX C

IN THE UNITED STATES DISTRICT COURT
FOR THE SOUTHERN DISTRICT OF MISSISSIPPI
JACKSON DIVISION

Civil Action No. J74-307(R)

THE PINEY WOODS COUNTRY LIFE
SCHOOL, ET AL.,
Plaintiffs,

vs.

SHELL OIL COMPANY,
Defendant.

MOTION FOR CERTIFICATION UNDER RULE 54(b)

Come now the Plaintiffs, by their attorneys, and respectfully move the Court for a certification under Rule 54(b) of the Federal Rules of Civil Procedure and in support of this motion would show the following:

1. On May 3, 1982, this Court rendered its Opinion in this case.

2. The Court in its Opinion denied all of the Plaintiffs' claims in this case except the claim pertaining to market value of gas used for "off-lease" fuel, and the Court requested additional proof on this sole claim.

3. The determination of the amount of damages to each class member will require the following:

(a) Study by gas marketing experts as to the market value of natural gas for each quarter, or month,

from 1974 to the present pursuant to the Court's opinion and further instructions on how market value should be determined.

(b) Detailed accounting information must be developed and presented to the Court showing the amount of revenue paid to each drilling unit for off-lease fuel and the amount due based on market value.

(c) The title records for each class member must be checked to determine whether any interests have changed since the trial, and then the damages for each class member must be computed.

4. If further hearings are conducted to make final computations based on the Court's opinion, and the Court is ultimately reversed as to the method for determining market value, or on any other point, then the process will have to be repeated.

5. If the court certifies for appeal all claims except for the damages due for market value on off-lease fuel, then a final decision on these issues can be made and one, and only one, additional hearing will be needed to determine damages.

6. Certification of the claims which have now been finally decided by the court will not result in the appellate court having to decide the same claims more than once even if there are subsequent appeals. Sound judicial administration and equity require certification.

7. There is no just reason for delaying an appeal of the claims which have been finally decided. The court should direct entry of final judgment as to such claims without delay.

WHEREFORE, the Plaintiffs respectfully move this Court for certification under Rule 54(b) of the Federal Rules of Civil Procedure to permit them to take an immediate appeal of all of those claims which have been finally determined by this Court.

Dated this the 18th day of June, 1982.

Respectfully submitted,

THE PINEY WOOD COUNTRY LIFE SCHOOL, ET AL.
By Their Attorneys,
HEIDELBERG, WOODLIFF & FRANKS
WATKINS LUDLAM & STENNIS
By: /s/ George F. Woodliff III
George F. Woodliff III

NOTICE OF MOTION

TO WILLIAM F. GOODMAN, JR.

This motion will be heard on June 30, 1982, at 1:30 p.m. in the office of Judge Dan M. Russell in Jackson, Mississippi.

/s/ George F. Woodliff III
George F. Woodliff III

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OF COUNSEL

CERTIFICATE OF SERVICE

I hereby certify that I delivered a true and correct copy of the above and foregoing Motion for Certification Under Rule 54(b) to William F. Goodman, Jr., Esq., Attorney for the Defendant Shell Oil Company at his office address on June 18, 1982.

/s/ George F. Woodliff, III
George F. Woodliff, III

APPENDIX D

(Filed June 25, 1982)

UNITED STATES DISTRICT COURT
SOUTHERN DISTRICT OF MISSISSIPPI
JACKSON DIVISION

Civil Action No. J74-307(R)

THE PINEY WOODS COUNTRY LIFE SCHOOL, et al.,
Plaintiffs,

vs.

SHELL OIL COMPANY,
Defendant.

RESPONSE TO PLAINTIFFS' MOTION FOR CERTIFICATION UNDER RULE 54(b)

The defendant, Shell Oil Company, in response to plaintiffs' motion for certification under Rule 54(b), states:

1. The Court in its Opinion rendered May 3, 1982, denied all of plaintiffs' claims but did permit the parties to offer further proof on the sole question of the market value of gas used for "off-lease" fuel.

2. In an effort to defer the likely uneconomic submission of proof, plaintiffs seek certification under Rule 54(b). Plaintiffs' motion fails, however, to make the necessary specification of alleged multiple claims finally decided and appropriate for certification.

3. The essence of plaintiffs' action was their claim for royalty computed on market value without deduction of processing costs. Even if more than a single claim was alleged, there is a strong interrelationship between

claims and the claims are so intertwined that a substantial likelihood of appellate court consideration of the same issues on successive appeals exists.

4. The mere possibility of a hearing after appeal to determine damages after appeal does not justify the immediate appeal of interwoven claims.

5. Plaintiffs' claim for royalty computed on market value cannot be split to allow expedited appellate court consideration of alternative grounds for recovery.

6. Just reason for delaying an appeal is present; this case should be reviewed only as a single judicial unit.

WHEREFORE, defendant requests that this Court deny plaintiffs' motion for certification under Rule 54(b) and enter judgment in strict accordance with its Opinion of May 3, 1982.

THIS 25th day of June, 1982.

Respectfully submitted,

W. F. GOODMAN, JR.
PAUL H. STEPHENSON, III
Post Office Box 650
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By /s/ Paul H. Stephenson, III
Attorney for Defendant

COUNSEL:

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Jackson, Mississippi 39205
601/948-6470

CERTIFICATE OF SERVICE

The undersigned counsel of record for the defendant certifies he has this day delivered a true and correct copy of the above and foregoing Response to Plaintiffs' Motion for Certification under Rule 54(b) to Ernest G. Taylor, Jr., Esquire and George F Woodliff, III, Esquire, two of the attorneys of record for the plaintiffs.

This the 25th day of June, 1982.

/s/ Paul H. Stephenson, III
Of Counsel

APPENDIX E

(Filed July 2, 1982)

IN THE UNITED STATES DISTRICT COURT
FOR THE SOUTHERN DISTRICT OF MISSISSIPPI
JACKSON DIVISION

Civil Action No. J74-307(R)

THE PINEY WOODS COUNTRY LIFE SCHOOL, ET AL.,
Plaintiffs,

vs.

SHELL OIL COMPANY,
Defendant.

CERTIFICATION UNDER RULE 54(b)

The Court having considered the Plaintiffs' Motion for Certification Under Rule 54(b) is of the opinion that said Motion should be granted.

IT IS HEREBY CERTIFIED, in accordance with Rule 54(b), Fed. R. Civ. P.,

1. That the Court has directed the entry of final judgment as stated in the attached Order entitled Final Judgment; and

2. That the Court has determined that the claims so certified are separable and there is no just reason for delay.

In support of this certification, the Court makes the following findings:

1. On May 3, 1982, this Court rendered its Opinion in this case.

2. The Court in its Opinion denied all of the Plaintiffs' claims in this case except the claim pertaining to market value of gas used for "off-lease" fuel, which is

gas that is produced from one unit but is used to operate facilities on another, and the Court requested additional proof on this sole claim.

3. The determination of the amount of damages to each class member will require the following:

(a) Study by gas marketing experts as to the market value of natural gas for each quarter, or month, from 1974 to the present pursuant to the Court's opinion and further instructions on how market value should be determined.

(b) Detailed accounting information must be developed and presented to the Court showing the amount of revenue paid to each drilling unit for off-lease fuel and the amount due based on market value.

(c) The title records for each class member must be checked to determine whether any interests have changed since the trial, and then the damages for each class member must be computed.

4. If, prior to appeal, further hearings were conducted to make final computations based on the Court's opinion, and the court was reversed on any point, then the process would have to be repeated.

5. The Court's certification for appeal of all claims, except for the damages due for market value on off-lease fuel, assures that one, and only one, additional hearing will be needed to determine damages.

6. Certification of the claims which have now been finally decided by the court will not result in the appellate court having to decide the same claims more than once even if there are subsequent appeals. Sound judicial administration and equity require certification.

This the 23rd day of July, 1982.

/s/ Dan M. Russell, Jr.
United States District Judge

APPENDIX F

(Filed July 26, 1982)

IN THE UNITED STATES DISTRICT COURT
FOR THE SOUTHERN DISTRICT OF MISSISSIPPI
JACKSON DIVISION

Civil Action No. J74-307 (R)

THE PINEY WOODS COUNTRY LIFE SCHOOL, ET AL.,
Plaintiffs,

vs.

SHELL OIL COMPANY,
Defendant.

FINAL JUDGMENT

This action having come on for trial before the Court, the Plaintiffs and the Defendant having announced ready for trial after issue joined, and the Court having heard all of the evidence offered by all parties and having been furnished briefs and having heard the arguments of counsel, and the Court having entered findings of fact and conclusions of law in an Opinion rendered May 3, 1982.

IT IS, THEREFORE, ORDERED AND ADJUDGED that the Court denies all of the Plaintiffs' claims except for their claim for royalty computed on the market value of "off-lease" fuel which is gas that is produced from one unit but is used to operate facilities on another unit. The Court shall receive further proof on the amount of damages due on this claim.

IT IS FURTHER ORDERED AND ADJUDGED that the Court has denied and does hereby enter final judgment as to each of the following claims:

1. Plaintiffs' claim for damages and injunctive relief for Defendant's alleged violation of §§ 1 and 2 of the Sherman Act.

2. Plaintiffs' claim for damages and injunctive relief from alleged improper and excessive charges made against their royalty interests for Shell's gathering system, gas and sulfur plants, and pipeline to Yazoo City.

3. Plaintiffs' claim for damages and injunctive relief for Defendant's alleged breach of its implied duty to pay royalty based on market value on all gas sold by the Defendant.

4. Plaintiffs' claim for damages and injunctive relief for Defendant's alleged breach of its express duty, under applicable leases, to pay royalty based on market value on gas sold off the leased premises.

5. Plaintiffs' claim for damages and injunctive relief for Defendant's alleged breach of its express duty under the applicable leases, to pay royalty based on market value for all gas used off the leased premises as plant fuel.

6. Plaintiffs' claim for attorneys' fees and costs, including expert expenses, due to Defendant's alleged bad faith in handling Plaintiffs' royalty payments.

7. Plaintiffs' claim for pre-judgment interest.

IT IS FURTHER ORDERED AND ADJUDGED that the Court will defer a hearing on the amount of damages due for royalty computed on the market value of "off-lease" fuel, as defined above, until the other issues in this case have been finally resolved on appeal.

SO ORDERED AND ADJUDGED this the 23rd day of July, 1982.

/s/ Dan M. Russell, Jr.
United States District Judge

APPROVED AS TO FORM:

ATTORNEYS FOR PLAINTIFFS

/s/ George F. Woodliff III
George F. Woodliff III

/s/ Ernest G. Taylor, Jr.
Ernest G. Taylor, Jr.

ATTORNEYS FOR DEFENDANT

.....

W. F. Goodman, Jr.

APPENDIX G

IN THE UNITED STATES COURT OF APPEALS
FOR THE FIFTH CIRCUIT

No. 82-4287

THE PINEY WOODS COUNTRY LIFE SCHOOL, ET AL.,
Plaintiffs-Appellants,

vs.

SHELL OIL COMPANY,
Defendant-Appellee.

MOTION FOR RULING ON JURISDICTION AND TO DISMISS APPEAL OR, ALTERNATIVELY, TO LIMIT ISSUES ON APPEAL

The Defendant-Appellee, Shell Oil Company ("Shell"), moves the Court for a ruling on jurisdiction, and to dismiss the appeal or in the alternative to limit the issues on appeal, and would show the following:

The Claim For Relief

1. This diversity action brought by a class of royalty owners claims underpayment of royalty from their interests in a group of gas fields in Mississippi, coupled with Sherman Act allegations and a prayer for attorneys' fees and prejudgment interest. *Piney Woods Country Life School v. Shell Oil Company*, 539 F. Supp. 957 (S.D. Miss. 1982). The class asserts a two-pronged right to additional royalty, specifically challenging (a) the industry practice whereby both working interest and royalty owners share in costs incurred by the lessee (Shell) in processing and

transporting gas in fulfillment of its marketing responsibilities, and (b) the payment of royalty calculated on the basis of actual proceeds received from the sale of gas rather than calculated on the basis of a theoretical fluctuating "market value".

The Partial Decision Below

2. The District Court held that: (a) working interest and royalty owners share in costs of processing and transportation, 539 F. Supp. at 972, and (b) royalty attributable to gas *sold* was properly calculated on the basis of proceeds received by the lessee, 539 F. Supp. at 977.[1]

The Unresolved Questions Below

3. The District Court found that royalty attributable to gas *used* by Shell for rig fuel on other leases ("off-lease fuel") should be computed on the market value of gas so used, 539 F. Supp. at 977.[2] Due to the lack of relevant evidence offered by the class addressing comparability the District Court concluded there was a necessity for further proof as to the value of this off-lease rig fuel. 539 F. Supp. at 987. The District Court has not yet decided whether or not in paying royalty on gas used off of the respective leases for rig fuel Shell placed a proper value on such gas and, if not, what value should have been applicable to this particular gas.

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1. The Sherman Act allegations were abandoned. The District Court found attorneys' fees and prejudgment interest to be inappropriate. 539 F. Supp. at 961, 988.

2. The District Court considered the "market value" concept only with respect to gas not sold by Shell and used by it for off-lease rig fuel.

The Status On Appeal

4. The plaintiff class contends that this appeal presents five principal issues for appellate review.

(a) One "issue" invites this Court to interject itself into the very question deferred and not yet decided by the District Court (the question of the proper value to be placed on gas used for off-lease rig fuel). No finality has occurred below as to the ability of the class to establish relevant market value for off-lease rig fuel and there is no judgment ending that question on the merits; nevertheless the class urges this Court to honor plaintiffs' proof as to the market value of such gas, i.e. to render an advisory opinion on the methods available to prove such an evaluation.[3]

(b) Three other "issues", interwoven with and interrelated to each other and to the advisory issue noted above, invite this Court to take the portion of the opinion below dealing only with gas used for off-lease rig fuel and to apply the same to all gas. Even though in the view of the District Court it retains jurisdiction of the only part of the case in which "market value" has relevance, the class seeks an appellate opinion that the "market value" concept is applicable to all gas.[4]

(c) One "issue" invites this Court to review, preliminarily and in advance of other interwoven and interrelated questions, the propriety of royalty owners sharing with working interest owners the costs of processing sour

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3. Point IV, Brief For Appellants, pp. 2, 26-29. No judgment has been entered below respecting the damages, if any, recoverable under the market value concept.

4. Points I, II and III, Brief For Appellants, pp. 1-2, 12-25. The "market value" portion of the case has not been finally resolved below on the merits.

gas.[5] Premature appellate consideration of this single part of the case will likely result in duplicative judicial efforts at the appellate level.

Jurisdiction

5 (a). Jurisdiction of this action remains in the District Court and will remain so until a final decision has been entered adjudicating the unresolved questions.

This action asserts a legal right to additional royalty, and to date has been adjudicated in part and deferred in part by the District Court.

(b). In the alternative, there can be no jurisdiction in this Court of issues which are interwoven with and interrelated to issues remaining unresolved below.

Certification

6. Jurisdiction can not be conferred upon this Court by the District Court's purported Certification under Rule 54(b).

The District Court abused its discretion in making the Certification; the theory of "multiple claims" is not applicable where the result is to split into segments an alleged legal right to additional royalty; the Certification is contrary to the historic federal policy against piecemeal appeals.

Alternatively, the Certification did not contemplate that the appellants would abuse the certification process and seek on partial appeal: (a) an advisory ruling on the questions deferred by the District Court; and (b) a ruling on other questions based upon an alleged factual

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5. Point V, Brief For Appellants, pp. 2, 29-47.

and legal relationship to and dependency upon the questions deferred by the District Court.

WHEREFORE, Shell respectfully moves the Court to dismiss the appeal for lack of jurisdiction or, alternatively, to limit the issue on this appeal to Point V of the Brief For Appellants.

Respectfully submitted,

/s/ Paul H. Stephenson, III
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Jackson, Mississippi 39205
Of Counsel for Defendant-Appellee

CERTIFICATE

The undersigned attorney of record for the Defendant-Appellee certifies that he has this day personally delivered a true and correct copy of the foregoing Motion to each of the following:

Kenneth I. Franks, Esquire
1030 Capital Towers
Jackson, Mississippi 39201

Ernest G. Taylor, Jr., Esquire
20th Floor, Deposit Guaranty Plaza
Jackson, Mississippi 39201

L. Arnold Pyle, Esquire
111 East Capitol Street
Jackson, Mississippi 39201

the attorneys of record for Plaintiffs-Appellants.

This 10th day of March, 1983.

/s/ Paul H. Stephenson, III
Paul H. Stephenson, III